FEDERAL TRADE COMMISSION DECISIONS

FINDINGS, OPINIONS AND ORDERS

JULY 1, 1984 TO DECEMBER 31, 1984

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FEDERAL TRADE COMMISSION DECISIONS

Findings, Opinions and Orders

IN THE MATTER OF

AMERICAN MEDICAL INTERNATIONAL, INC., ET AL.

FINAL ORDER, OPINION, ETC. IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 7 OF THE CLAYTON ACT

Docket 9158. Complaint, July 30, 1981—Final Order, July 2, 1984

This final order requires a Beverly Hills operator of the nation's third largest chain of proprietary hospitals, among other things, to divest French Hospital in San Luis Obispo, California, to a Commission-approved buyer within twelve months from the effective date of the order. The purpose of the divestiture is to reestablish the facility as a viable competitor in San Luis Obispo County, and respondent is required to take all measures necessary to prevent any deterioration of the hospital's present operating abilities or market value, pending divestiture. The order further requires the company to provide the Commission, for a period of ten years, with advance notification of its intention to acquire any hospital located in the states specified in the order.

Appearances

For the Commission: *L. Barry Costilo, Peter M. Kazon, Sharon Eubanks, Oscar M. Voss,* and *Judith A. Moreland.*

For the respondent: *William T. Coleman, Jr., Richard C. Warmer, Richard G. Parker, Christopher W. Savage,* and *Mark D. Plevin, O'Melveny & Myers,* Washington, D.C.

COMPLAINT

The Federal Trade Commission having reason to believe that American Medical International, Inc., and its wholly-owned subsidiary corporation hereinafter also named as respondent, corporations subject to the jurisdiction of the Commission, have acquired the stock or assets of the hospital hereinafter described, in violation of Section 7 of the Clayton Act, as amended (15 U.S.C. 18), and having further reason to believe that respondents have engaged in unfair methods of competition in violation of Section 5 of the Federal Trade Commission

Act, as amended (15 U.S.C. 45), and that a proceeding in resp
thereof is in the public interest, hereby issues its complaint pursu
to the provisions of Section 11 of the aforesaid Clayton Act as ame
ed (15 U.S.C. 21), and Section 5(b) of the Federal Trade Commiss
Act, as amended (15 U.S.C. 45(b)), stating its charges as follows:

Respondents

1. Respondent American Medical International, Inc., hereina
"AMI," is a corporation organized and existing under the laws of
State of Delaware, with its principal executive offices at 414 No
Camden Drive, Beverly Hills, California.

2. AMI is primarily engaged in the operation and managemen
proprietary hospitals in the United States and in foreign countries
AMI's fiscal year 1980, it had total revenues of approximately $
million. It owns approximately 64 hospitals in the United States
abroad. It is the third largest proprietary hospital chain in the Uni
States. [2]

3. Respondent AMISUB (French Hospital), hereinafter "AMIS
French," is a wholly-owned subsidiary corporation of AMI, organi
and doing business under the laws of the State of California, with
principal office at 414 North Camden Drive, Beverly Hills, Califor
AMISUB French was established by AMI for the purpose of acqui
and operating French Hospital located in San Luis Obispo, Califor

Trade and Commerce

4. At all times relevant herein, the respondents have been and
now engaged in commerce within the meaning of the Clayton Act
amended, and are corporations whose businesses are in or affec
commerce within the meaning of the Federal Trade Commission
as amended. AMI does business in a number of states. AMI and
hospitals in San Luis Obispo County, California, among other thi

(a) purchase substantial amounts of supplies, equipment and m
cines from sources outside of the State of California;

(b) receive substantial revenues from private and governme
insurers located outside of the State of California; and

(c) treat some patients who travel from or reside outside of the S
of California.

5. AMI, through its wholly-owned subsidiaries, presently owns
operates three of the five general acute care hospitals in San
Obispo County, California. These hospitals are Sierra Vista Hosp
Arroyo Grande Community Hospital and French Hospital. A
ownership of each of these hospitals was obtained by means of s
rate acquisitions.

6. General acute care hospitals, hereinafter sometimes referred to as "hospital(s)," are health facilities, other than federally-owned facilities, with an organized medical staff which provide 24 hour inpatient care, including at least the following services: nursing, surgical, anesthesia, laboratory, radiology, pharmacy and dietary services. General acute care hospitals is the relevant product market.

7. San Luis Obispo County, California, and/or parts thereof, are the relevant geographic markets.

8. Barriers to entry into the hospital market in San Luis Obispo County are high. [3]

COUNT I

The Acquisition

9. On July 18, 1979, AMI, through AMISUB French, acquired sole ownership of the assets and related facilities of the proprietary French Hospital in the city of San Luis Obispo, California. It acquired the assets used by French Hospital from Central Coast Hospital Company, a limited partnership; French Hospital Corporation; Central Coast Clinic Company, a limited partnership; and French Medical Clinic, Inc.

10. At the time of this acquisition, French Hospital competed with AMI's Sierra Vista and Arroyo Grande Community hospitals. Sierra Vista was the largest hospital in the city of San Luis Obispo, California with approximately a 43% share of hospital beds in the city, and French Hospital was the second largest hospital in the city with approximately a 34% share of hospital beds in the city. The only other hospital in the city was the nonprofit San Luis Obispo General Hospital, which was operated by the county primarily for indigent patients.

11. At the time of its acquisition by AMI, French Hospital had approximately a 24% share of hospital beds in San Luis Obispo County and AMI's two other hospitals had a combined share of approximately 44% of the hospital beds in the county. AMI's combined share of filled hospital beds in San Luis Obispo County is higher than the figures set forth above.

Effects

12. The effects of the French Hospital acquisition by AMI, through its wholly-owned subsidiary, may be to lessen competition substantially or tend to create a monopoly in the relevant product and geographic markets enumerated in Paragraphs 6 and 7, above, in the following ways, among others:

(a) actual and potential competition has been eliminated among French, Arroyo Grande Community and Sierra Vista hospitals;

(b) concentration has been substantially increased;

(c) already high barriers to entry have been increased and new entry into the market has been foreclosed;

(d) respondents have obtained a dominant market position; [4]

(e) patients, physicians, and large group purchasers of hospital services, such as health maintenance organizations, may be denied the benefits of free and open competition based on price, quality, and service in choosing among hospitals.

Violation Charged

13. The acquisition of French Hospital constitutes a violation of Section 7 of the Clayton Act, as amended, and Section 5 of the Federal Trade Commission Act, as amended.

COUNT II

14. The allegations of Paragraphs 1 through 11 of this complaint are incorporated by reference herein.

15. Beginning sometime in the past and continuing to the present AMI, through its wholly-owned subsidiaries, has, with specific intent to exclude competitors and maintain the power to control delivery of hospital services, attempted to monopolize and has otherwise engaged in unfair methods of competition in the market for general acute care hospital services in San Luis Obispo County or parts thereof.

16. In furtherance of the conduct alleged in Paragraph 15, AMI has engaged in the following acts and practices, among others:

(a) acquired French Hospital;

(b) prevented a competing national proprietary hospital chain from purchasing French Hospital and offering competition to AMI's two hospitals located in San Luis Obispo County, California; and

(c) directed or authorized its three hospitals in San Luis Obispo County to take a united position in refusing to compete with each other by offering price and other concessions to Los Padres Group Health, an individual practice association health maintenance organization.

17. The acts and practices referred to in Paragraph 16 are in or affect commerce.

18. The effects, tendency and capacity of the conduct set forth in Paragraphs 15 and 16 are to restrain trade and eliminate [5] competition in the relevant product and geographic markets enumerated in Paragraphs 6 and 7, above, in the following ways, among others:

(a) create a dangerous probability of monopoly, which would (i) provide respondents with the power to raise prices and exclude competitors, and (ii) reduce respondents' incentives to provide high quality services;

(b) increase already high barriers to entry and foreclose new entry into the market;

(c) provide respondents with a dominant market position;

(d) deny patients, physicians, and large group purchasers of hospital services, such as health maintenance organizations, the benefits of free and open competition among hospitals based on price, quality, and service.

19. The course of conduct and effects alleged in Paragraphs 14 through 18 are continuing and will continue in the absence of the relief herein requested.

Violation Charged

20. The course of conduct and effects alleged in Paragraphs 14 through 18 violates Section 5 of the Federal Trade Commission Act, as amended.

INITIAL DECISION BY

ERNEST G. BARNES, ADMINISTRATIVE LAW JUDGE

JULY 27, 1983

PRELIMINARY STATEMENT

The complaint in this matter issued on July 30, 1981, charging American Medical International, Inc. ("AMI"), a corporation, and AMISUB (French Hospital), a corporation, with violations of Section 7 of the Clayton Act, as amended (15 U.S.C. 18 [1976]), and Section 5 of the Federal Trade Commission Act, as amended (15 U.S.C. 45 [1976]).

Count I of the complaint alleges that AMI, through a wholly-owned subsidiary AMISUB (French Hospital), acquired all the assets and related facilities of the proprietary French Hospital in the city of San Luis Obispo, California. The effects of the acquisition, it is alleged, may be to lessen competition substantially or tend to create a monopoly in the general acute care hospital market in San Luis Obispo County, California, and/or parts thereof, in the following ways, among others:

(a) actual and potential competition has been eliminated among French, Arroyo Grande Community and Sierra Vista hospitals; [2]

(b) concentration has been substantially increased;

(c) already high barriers to entry have been increased and new entry into the market has been foreclosed;

(d) respondents have obtained a dominant market position;

(e) patients, physicians, and large group purchasers of hospital services, such as health maintenance organizations, may be denied the benefits of free and open competition based on price, quality, and service in choosing among hospitals.

(Complaint, ¶ 13) The acquisition is alleged to violate Section 7 of the Clayton Act, and Section 5 of the Federal Trade Commission Act.

Count II of the complaint alleges that AMI, through its wholly-owned subsidiaries, has, with specific intent to exclude competitors and maintain the power to control delivery of hospital services, attempted to monopolize and has otherwise engaged in unfair methods of competition in the market for general acute care hospital services in San Luis Obispo County, or parts thereof. In furtherance of the aforesaid conduct, it is alleged that AMI has engaged in the following acts and practices, among others:

(a) acquired French Hospital;

(b) prevented a competing national proprietary hospital chain from purchasing French Hospital and offering competition to AMI's two hospitals located in San Luis Obispo County, California; and

(c) directed or authorized its three hospitals in San Luis Obispo County to take a united position in refusing to compete with each other by offering price and other concessions to Los Padres Group Health, an individual practice association health maintenance organization.

(Complaint, ¶ 16) It is alleged that the effects, tendency and capacity of this conduct are to restrain trade and eliminate competition in the general acute care hospital market in San [3] Luis Obispo County, California, and/or parts thereof, in the following ways, among others:

(a) create a dangerous probability of monopoly, which would (i) provide respondents with the power to raise prices and exclude competitors, and (ii) reduce respondents' incentives to provide high quality services;

(b) increase already high barriers to entry and foreclose new entry into the market;

(c) provide respondents with a dominant market position;

(d) deny patients, physicians, and large group purchasers of hospital services, such as health maintenance organizations, the benefits of free and open competition among hospitals based on price, quality, and service.

(Complaint, ¶ 18) This course of conduct and effects thereof are alleged to violate Section 5 of the Federal Trade Commission Act, as amended.

The Notice of Contemplated Relief included with the complaint stated that divestiture of the acquired assets, including subsequent improvements, may be required and that respondents may be prohibited, without prior Commission approval, from making future acquisitions of general acute care hospitals in areas where respondents already own or operate such a hospital.

On October 8, 1981, respondents filed an answer to the complaint admitting some of the complaint allegations, but denying those paragraphs of the complaint that allege violations of law. Respondents affirmatively stated that the complaint failed to state a claim upon which relief can be granted, and that the Commission is without jurisdiction to entertain the complaint allegations in that none of the alleged acts had a substantial effect on interstate commerce.

The first prehearing conference was held on November 13, 1981, and trial commenced on September 20, 1982. Complaint counsel, during the opening statement at the commencement of trial on September 20, 1982, abandoned all claims regarding Los Padres Group Health. (Tr. 74; *see* Complaint, ¶ 16(c)) Complaint counsel offered a rebuttal case which consisted entirely of documents. Respondents' surrebuttal case was comprised of documents and the testimony of one [4] witness. The last date of trial was March 2, 1983, and the record for the reception of evidence was closed on March 28, 1983. The record consists of 2531 pages of transcript and in excess of 450 exhibits. Complaint counsel called ten witnesses during the case-in-chief and respondents called a total of thirteen witnesses.[1]

This proceeding is now before the Administrative Law Judge for decision based upon the complaint, the answer, pleadings, testimony and documentary evidence of record, proposed findings of fact and conclusions of law, and legal memoranda submitted by the parties. These submissions have been given careful consideration and, to the extent not adopted herein in the form proposed or in substance, are rejected as not supported by the record or as immaterial. All motions not heretofore or herein specifically ruled upon, either directly or by the necessary effect of the conclusions in this Initial Decision, are hereby denied.

Having heard and observed the witnesses and after having carefully reviewed the entire record in this proceeding, together with the proposed findings of fact and conclusions of law submitted by the parties, the Administrative Law Judge makes the following findings of fact and conclusions, and issues the Order set out at the end hereof.[2]

[5]

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[1] Respondents' Proposed Findings of Fact and Conclusions of Law ("RPF") identify each witness who appeared during the trial. (RPF 0.16) Complaint counsel prepared a similar listing. (CPF, p. viii–ix) Mr. Charles Reilly, Senior Vice President, AMI, was called as a witness by both complaint counsel and respondents. (RPF 0.16, pp. 6–8) Norman Loftin, Senior Vice President, AMI, who testified in defense, was recalled by respondents as a surrebuttal witness.

[2] The findings of fact include references to supporting evidentiary items in the record. The supporting evidence cited in each instance is not necessarily all-inclusive of the record evidence. The following abbreviations have been used:

F. - Findings of this Initial Decision followed by the number of the finding(s) being referenced. Refer-

(footnote cont'd)

I. FINDINGS OF FACT

A. *Identity of the Parties*

1. Respondent American Medical International, Inc. ("AMI") is a corporation organized and existing under the laws of the State of Delaware, with its principal executive offices located at 414 North Camden Drive, Beverly Hills, California. (Complaint ¶ 1; Answer ¶ 2) AMI is primarily engaged in the owning, operation and management of general acute care hospitals in the United States and in foreign countries. (Reilly, 737) More than 85 percent of AMI's revenues are derived from its operation of such institutions. (Weisman, 1712–13) AMI also provides health care services through subsidiaries to hospitals and physicians which include medical-technical support services, financial and management services, and health care development services. (CX 10N; Weisman, 1712–13) In AMI's fiscal year 1982, it had total operating revenues of approximately $1.4 billion and net income of $78.8 million. (RX 5823 at 32) It owns, operates, or has under construction 72 hospitals in the United States and 24 hospitals abroad. (RX 5823 at 50–51; Reilly, 755; Weisman, 1747–48) AMI is the nation's third largest proprietary hospital chain in terms of domestic hospitals owned. (Reilly, 1797) AMI currently owns and operates three hospitals in San Luis Obispo County, California. They are Sierra Vista Hospital ("Sierra Vista") and French [6] Hospital ("French") located in the city of San Luis Obispo, California, and Arroyo Grande Community Hospital ("Arroyo Grande") located in Arroyo Grande, California. (RX 5823 at 50)

2. Respondent AMISUB (French Hospital) is a wholly-owned subsidiary corporation of AMI, organized and existing under the laws of the State of California, with its principal offices at 414 North Camden Drive, Beverly Hills, California. (Complaint ¶ 3; Answer ¶ 4) AMISUB (French Hospital) was established by AMI for the purpose of acquiring and operating French Hospital. (Complaint ¶ 3; Answer ¶ 4) For purposes of this action, AMI and AMISUB (French Hospital) can be treated as a single entity.[3] (Prehearing Conference [Nov. 13, 1981], 3, 36)

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ences to the transcript are designated by the name of the witness followed by the transcript page number(s).

CX – Complaint counsel's exhibits followed by the exhibit number and the referenced page(s).
RX – Respondents' exhibits followed by the exhibit number and the referenced page(s).
CPF – Complaint counsel's Proposed Findings of Fact and Conclusions of Law.
CB – Complaint Counsel's Post-Trial Brief In Support of Its Proposed Findings of Fact and Conclusions of Law.
RPF – Respondents' Proposed Findings of Fact and Conclusions of Law.
RB – Brief in Support of Respondents Proposed Findings of Fact and Conclusions of Law.

[3] Hereafter "AMI" is used to refer to both AMI and AMISUB (French Hospital).

B. *Identity of Other Firms Involved in the Challenged Acquisition*

3. Central Coast Hospital Company at the time of the acquisition was a limited partnership organized and existing under the laws of the State of California. (CX 68L) The partnership consisted of both general and limited partners, all but two of whom were physicians. (Friedmann, 1602–03) This partnership owned the land, buildings, and other improvements relating to French Hospital. (Answer ¶ 9(a)) Central Coast Hospital Company had one wholly-owned subsidiary, French Hospital Corporation. The Company and its subsidiary filed separate federal and California state income tax returns. (CX 35S) In the year ending June 30, 1978, Central Coast Hospital Company and its subsidiary, French Hospital Corporation, had total revenues of $8,171,482 and a combined net income of $745,160. (CX 35–0)

4. French Hospital Corporation is a corporation organized and existing under the laws of the State of California. (CX 20) French Hospital Corporation operated French Hospital, owned or leased the hospital's equipment, and held the license for the hospital prior to the acquisition. (Answer ¶ 9(c); CX 41B; F. 8) French Hospital Corporation was a wholly-owned subsidiary of Central Coast Hospital Company. (CX 35A) Central Coast Hospital Company leased to French Hospital Corporation the property on which French Hospital is located and the improvements on that property, including the buildings housing the hospital's facilities. (CX 534; CX 730–O–P) [7]

5. Central Coast Clinic Company was a limited partnership organized and existing under the laws of the State of California. (CX 73G) Many of its partners were also partners in Central Coast Hospital Company which owned French Hospital. (Boyd, 363–64) Central Coast Clinic Company owned the land and building adjacent to French Hospital which comprised the French Medical Clinic prior to the acquisition. (CX 41B) Central Coast Clinic Company had one wholly-owned subsidiary, French Medical Clinic, Inc. (CX 41B; F. 6) In the year ending June 30, 1978, Central Coast Clinic Company and its subsidiary had assets valued at $3,216,603. (CX 35Z5)

6. French Medical Clinic, Inc. was a professional corporation organized and existing under the laws of the State of California. (CX 73B) French Medical Clinic, Inc. owned or leased the equipment used at French Medical Clinic. (CX 41, I) On February 22, 1974, French Medical Clinic, Inc. entered into a Master Lease Agreement with United Medical Leasing Company, Inc., Chicago, Illinois (RPF 14.9), covering a variety of medical equipment. (CX 70Z1–Z2) During 1974, the lessor assigned a part of this lease to a California limited partnership, Fraser Medilease, Pasadena, California. (CX 74A) United Medical Leasing Company, Inc. was the sole general partner in Fraser Medilease.

Lease payments to Fraser Medilease amounted to $673.27 per month. (CX 74B) French Medical Clinic, Inc. also had a lease with Xerox Corporation. (CX 70Z2) In 1979, French Medical Clinic, Inc. represented to AMI that its total rental costs with United Medical Leasing Company, Inc. would not exceed $202,587.50 per year. (CX 76) Other documents indicate that French Medical Clinic, Inc. had rental obligations amounting to $168,108 per year. (CX 49B, I) As of February 1979, French Medical Clinic, Inc. owned equipment valued at $700,000. (CX 41F, K; CX 35Z5)

7. AMISUB (French Clinic) is a wholly-owned subsidiary corporation of AMI, organized and existing under the laws of the State of California, with its principal offices at 414 North Camden Drive, Beverly Hills, California. (CX 70D–E; CX 70Z37) AMISUB (French Clinic) owns the computerized axial tomographic scanner ("CAT scanner") and x-ray and laboratory equipment AMI purchased from French Medical Clinic, Inc. (CX 70D–F, CX 71A, F)

C. *The Acquisition*

8. On July 19, 1979, AMI acquired from Central Coast Hospital Company all of the common stock of French Hospital Corporation. (CX 63; CX 68E–G, Z25) That corporation operated French Hospital (Answer ¶ 9(c)); held the license necessary to operate it (CX 85; Friedmann, 1601–02); owned or leased the [8] hospital's equipment (CX 41B);[4] and held a long-term lease which covered both the property on which French Hospital is located and the improvements on that property, including the French Hospital building itself. (CX 534; CX 730–O–P) In the same transaction AMI also acquired from Central Coast Hospital Company its other assets, excluding cash, cash equivalents, and certain notes receivable. (CX 63; CX 68E, G) Those assets were: (a) the Company's ownership interest in the French Hospital premises leased to French Hospital Corporation, and (b) a vacant lot. (CX 41B; CX 58L; CX 68E, G; CX 534)

9. At the same time AMI purchased from French Medical Clinic, Inc. a CAT scanner and other x-ray and laboratory equipment. (CX 70D–F, W, X–Z–2; CX 78) While the purchase contract designated AMISUB (French Clinic) as the purchaser, AMI paid the entire consideration for the purchase from its own funds. (CX 60; CX 70D–F; CX 73D–F) AMISUB (French Clinic) also that day subleased from French Medical Clinic, Inc. space for use as a CAT scanning and x-ray facility

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[4] French Hospital Corporation held substantial amounts of leased, as well as owned, equipment. French Hospital Corporation held leases of hospital equipment with total original purchase price of approximately $1.5 million. (*See* CX 535, [lease agreement with American Financial Leasing & Services Company, Cincinnati, Ohio]; RX 5597L–V)

and a clinical laboratory.[5] (CX 71A, F) After the acquisition, the CAT scanner, at least, was used in connection with the operation of the hospital. (F. 167, n. 18; *see* CX 274H; CX 91)

10. The total cost to AMI of the transactions described above was $10,970,000. AMI issued to Central Coast Hospital Company 220,225 shares of stock, with a fair market value of approximately $6.5 million. (RX 5851B–D, H–Y; Loftin, 1508; Friedmann, 1594–95) In addition, AMI assumed approximately $3.9 million in long-term debt of Central Coast Hospital Company. (*Id.*) Finally, AMI paid $570,000 in cash for the CAT scanner, x-ray, and laboratory equipment. (CX 70E, G; CX 73D–F) By letter dated December 19, 1980, AMI was advised that the Commission was investigating the acquisitions. (CX 1010) [9]

D. *Description of the San Luis Obispo County Area and Location of Area Hospitals*

11. San Luis Obispo County, California is located midway between Los Angeles and San Francisco. In 1980, it had a population of 155,345. (CX 1064 at II–1) The main center of population in the county is the city of San Luis Obispo, which is also the county seat. (CX 217D) The population of the city in 1980 was 33,684. (CX 1064 at II–1, Data Supp.) The county is 3,184 square miles in size. It is bounded by Monterey County to the north; Santa Barbara County to the south; Kern County and the Temblor Range to the east; and the Pacific Ocean to the west. (CX 217D; RX 5826) The southern boundary between San Luis Obispo and Santa Barbara Counties follows the Cuyama and Santa Maria Rivers. (CX 217D; RX 5826) The topography varies from the relatively flat land in the southern-most section of the Arroyo Grande Valley to the peaks of five mountain ranges. (CX 217D)

12. Both industry observers and health planners have considered the existence of three separate subareas within the county: the North County, the South County, and the Central/Coast Area. (CX 188; CX 192J; CX 255C; CX 217Z10–11) Local health planners have recognized that each subarea should be considered a separate service area for health planning purposes. (CX 217Z10–11; CX 197N; RX 5467Z10; RX 5437Z47)

13. The South County is an area which stretches from Shell Beach in the north, to the Santa Maria River in the south (CX 188; 192J), and encompasses the so-called "5 Cities" of Pismo Beach, Arroyo Grande, Grover City, Oceano, and Nipomo. (CX 192J; CX 197D) Although parts of the South County are connected with the cities of

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[5] AMISUB (French Clinic) leased the CAT scanner and x-ray equipment back to French Medical Clinic, Inc. for several months (CX 79), apparently because French Hospital, unlike the Clinic, had to obtain government approval to operate the CAT scanner. (Boyd, 376; Friedmann, 1601)

Santa Maria and San Luis Obispo by Highway 101, public transportation consists of infrequent Greyhound bus service. (CX 217Z10; *see* RX 5468Z62)

14. The North County area consists of the area from the Cuesta Grade north to the county line. (Boyd, 344; CX 192J; CX 198B; CX 217Z12) Some towns in the north are as much as 45 minutes away from the South County area (CX 736C), and although "[t]he Santa Lucia Mountain Range which lies between the City of San Luis Obispo and the North County offers steep and hazardous grades" (CX 217Z10), automobile travel over a four-lane highway can be accomplished routinely. (Anderson, 255) Public transportation consists of infrequent Greyhound bus service. (CX 217Z10; *see* RX 5468Z62)

15. The Central/Coastal area includes the city of San Luis Obispo, Los Osos, Avila Beach, and Morro Bay. (CX 255C) The city of San Luis Obispo is the center of health services in the county. (CX 255H; RX 5435C) **[10]**

16. San Luis Obispo County is part of California Health Systems Area 8, over which the Mid-Coast Health Systems Agency has jurisdiction. (CX 1064 at I-1) There are five general acute care hospitals in San Luis Obispo County. (*See* CX 1064 at V-8; Anderson 235) French, Sierra Vista Hospital ("Sierra Vista") and San Luis Obispo General Hospital ("SLO General") are located in the city of San Luis Obispo. (CX 736B) Twin Cities Community Hospital ("Twin Cities") is located in the north area of the county in Templeton, California. (CX 736B; RX 5592) Arroyo Grande Community Hospital is located in the south area of the county in Arroyo Grande, California. (*Id.*)

17. Appendix A, a reproduction of RX 5592, illustrates the locations of the hospitals described in Findings 18–26 *infra.*

18. French Hospital is a 138-bed, general acute care hospital located in the city of San Luis Obispo, California. (CX 736B; Steacy, 144–45) It "has a pleasant and attractive physical plant, a respected and well qualified medical staff, a good employee staff, and is well respected in the community." (CX 306A) French, the second largest hospital in the county, was acquired by AMI on July 18, 1979, and is the focus of this proceeding. (CX 736B; Complaint ¶ 9) The hospital provides most acute care services with the exception of obstetrics. (CX 91; CX 274B)

19. The original French Hospital was a 35-bed facility located on Marsh Street in the city of San Luis Obispo that was owned by Dr. Edison French. (Friedmann, 1565) In 1972, Dr. French opened the new facility at the existing site on Johnson Avenue. The new hospital had 138 beds. (Friedmann, 1565) Dr. French also owned the French Clinic which consisted of a group of doctors who were paid a salary by Dr. French. (Harvey, 1640–41) These physicians had their offices in the French Clinic building adjacent to French Hospital. (Boyd, 363) In late

1975, Dr. French decided to sell the hospital and clinic. (Harvey, 1642) In July, 1976, the hospital was purchased by the Central Coast Hospital Company, a partnership consisting of 17 partners, sixteen doctors from the French Clinic plus Mr. Kenneth Friedmann. (Friedmann, 1569; CX 41B) These doctors also purchased the French Clinic. (Boyd, 364) In 1978, the partnership began negotiations for the sale of the hospital. (Friedmann, 1592) AMI purchased French on July 18, 1979. (F. 8–10)

20. Sierra Vista Hospital is a general acute care hospital located in the city of San Luis Obispo, California. (CX 736B; Steacy, 144–45) Sierra Vista is located approximately two miles from French. (CX 736C) Sierra Vista, the largest hospital in the county, has 172 licensed beds and is owned by [11] AMI. (CX 736B) AMI purchased Sierra Vista in July 1968. (Carlson, 1317–18) At that time, the hospital had 93 licensed beds. (Carlson, 1317) In December 1972, Sierra Vista occupied a patient tower that had been added to the original building, and the number of hospital beds was eventually increased to 172. (Carlson, 1318–20)

21. San Luis Obispo General Hospital is a general acute care hospital located in the city of San Luis Obispo, California. (CX 736B; Steacy, 144–45) SLO General and French are approximately one block apart. (CX 736C) SLO General has 78 licensed acute care beds and is a nonprofit facility owned by San Luis Obispo County. (CX 736B) It also has 14 licensed psychiatric beds. (CX 736B) SLO General has the fewest acute care beds of any hospital in the county. (*Id.*)

22. The occupancy rate at SLO General in 1979 was 37 percent. (RX 5436W) SLO General is viewed in the community as the primary obstetrics facility in the county, with contemporary modalities of practice and lower costs than other area facilities. (RX 5436Z28) SLO General also has a dialysis program that is not duplicated anywhere in the area. (Anderson, 267) Other than for obstetrics, however, few physicians use SLO General on a regular basis because it does not have the modern facilities they need. (Anderson, 305) SLO General, which is run by the county, has the legal obligation of caring for the medically indigent. (Bernhardt, 1298)

23. Arroyo Grande Community Hospital is a general acute care hospital located in San Luis Obispo County in the city of Arroyo Grande, California, about 15 miles south of the city of San Luis Obispo. (CX 736B; Steacy, 144–45) It is the only hospital in the South County area. (*See* RX 5592) Arroyo Grande has 79 acute care beds, one more than SLO General, and is owned by AMI. (CX 736B) It is smaller than AMI's hospitals in the city of San Luis Obispo and not as modern or as well-equipped as AMI's facilities there. (Schwam, 585–86) AMI

acquired Arroyo Grande as part of its 1972 merger with Chanco Medical Industries. (CX 9Z12)

24. Twin Cities Community Hospital is located in San Luis Obispo County in the city of Templeton, California, about 22 miles north of the city of San Luis Obispo. (CX 736B) Twin Cities has 84 licensed beds. (*Id.*) It is a for-profit hospital owned by National Medical Enterprises. (CX 736B) Twin Cities is a general acute care hospital. (Steacy, 144–45) It is the only hospital in the North County area. (*See* RX 5592)

25. Santa Maria, California is in Santa Barbara County, south of San Luis Obispo County. (RX 5826) Marian Medical Center and Valley Community Hospital are both located in Santa [12] Maria, 30 miles from the city of San Luis Obispo. (CX 736B) Marian Medical Center is a general acute care hospital with 125 licensed beds. It is a nonprofit facility owned by the Sisters of St. Francis of Penance and Christian Charity. (CX 736B; Steacy, 143–46) Valley Community Hospital is a general acute care hospital with 48 licensed beds. (CX 736B; Steacy, 148–49) It is a for-profit facility, owned by Summit Health. (CX 736B) Valley and Marian are approximately two miles apart. (CX 736C) These two hospitals serve the same community of patients and have, for the most part, the same medical staff. (Steacy, 149)

26. George L. Mee Memorial Hospital is located in Monterey County in King City, California. This is about 81 miles north of the city of San Luis Obispo. (CX 736B) Mee Memorial has 42 licensed beds and is owned by Southern Monterey County Memorial Hospital, Inc., a nonprofit organization. (CX 736B)

E. *Interstate Commerce*

27. AMI admits that it operates and manages hospitals in the United States and in foreign countries, and that it does business in a number of states. (Answer ¶ 3a, ¶ 5b) At the time AMI acquired French Hospital, AMI owned or leased 44 general acute care hospitals in the United States, located in nine states. (CX 729Z3) AMI also managed three hospitals in Arkansas and Texas. (CX 729Z3–Z4) Between June 1978 and July 1979, when it acquired French Hospital, AMI acquired four domestic hospitals, a computer-aided design and architectural firm, and a prepaid health care program, all of which were located in States other than California. (CX 729Z5–Z7; CX 731B) As of August 31, 1979, AMI provided cardio-pulmonary, diagnostic, and therapeutic services under contracts with hospitals in 40 states. (CX 729Z4) These operations are directed from AMI's headquarters in California. (*See* RX 5823)

28. At the time French Hospital Corporation was acquired by AMI, it had been making payments of $16,986.75 per month for several years under equipment lease agreements with Provident Bank; those

payments were sent to locations outside California (CX 535; CX 730N; CX 731B) prior to its acquisition by AMI. French Hospital received millions of dollars per year in interstate payments for hospital services rendered. (*See* F. 30) Those payments were received by French Hospital Corporation. (CX 735A) French Hospital, which was operated by French Hospital Corporation before the acquisition (Answer ¶ 9(c)), occasionally treated patients who did not reside in the state of California. (Answer ¶ 5(d))

29. AMI issued to Central Coast Hospital Company shares of AMI common stock worth approximately $6.5 million as part of [13] the purchase price for French Hospital. (RX 5851B–C; CX 65; F. 10) AMI obtained approval from the New York Stock Exchange for the listing on that exchange of the stock issued to Central Coast Hospital Company, as required by the contract for the acquisition of French Hospital. (CX 68Z14; CX 69A)

30. French, Sierra Vista, and Arroyo Grande make interstate purchases of substantial amounts of drugs, devices, equipment and supplies, and make interstate payment therefor; and receive substantial interstate payments for hospital services, as set forth in Appendix B. The funds used to cover the hospitals' Medicare reimbursement checks were Treasury funds drawn from the San Francisco Federal Reserve Bank, pursuant to letters of credit issued by the Baltimore, Maryland headquarters of the Health Care Financing Administration. (CX 735B) Some of those Treasury funds originated outside California. (CX 735B) Payments of the hospitals' Medicare reimbursement checks reduce, by the amount of the checks, the amount of Treasury funds transferred at the end of each business day from the San Francisco Federal Reserve Bank to the New York Federal Reserve Bank. (CX 735B) The hospitals' Medicare reimbursements are charged against two trust funds maintained on the books of the United States Treasury, headquartered in Washington, D.C. (CX 735A) A substantial part of the funding for those trust funds comes from payroll taxes and Medicare Part B premiums collected nationwide. (CX 735A–B) A major part of the interstate payments received by French Hospital and the interstate purchases and payments received by the other hospitals that are noted on Appendix B were received prior to AMI's acquisition of French Hospital.

31. The Vidar Division of TRW, Inc., which employs approximately 600 persons at its plant in San Luis Obispo, and is the second largest non-governmental employer in the San Luis Obispo area (RX 5435Q), had a health benefits plan for its employees and their dependents, effective April, 1981, which paid 100% of certain hospital charges, and 80% of certain other hospital charges (subject to a deductible and a $1,000,000 maximum lifetime benefit for major medical expenses)

incurred by an employee or dependent. (CX 561A, G–H, K–L, W–Z3) Benefits under the plan are paid on behalf of the employer by the Travelers Insurance Company. (CX 561B) All Travelers' payments for hospital services to AMI's hospitals in San Luis Obispo County are interstate payments. (CX 734B)

32. Payors that reimburse for hospital services on the basis of the reasonable costs of providing those services—such as Medicare and, until recently, Medi-Cal (*see* F. 33, 158)—will be affected to the extent that this acquisition affects those costs. (*See* F. 33) Third-party payors that [14] reimburse on the basis of hospital charges—*i.e.*, private insurance companies (*see* Guy, 661)—and self-pay patients, will be affected to the extent that this acquisition affects charges. (*See* F. 174–187)

33. The acquisition of French increased the "cost basis" of the hospital for Medicare purposes and therefore the amount of interstate Medicare payments French was entitled to receive. Under Medicare regulations, depreciation of hospital facilities and (for proprietary hospitals only) return on equity capital are "allowable costs" for Medicare reimbursement. (42 C.F.R. 405.415, 405.429 (1982)) The "cost basis" of a particular French asset, for purposes of calculating depreciation and return on equity, is governed by those Medicare regulations. To the extent that AMI claims a higher cost basis for French than that claimed by the previous owners, Medicare reimbursement will be increased. This possibility was recognized by Mr. Steven Takahashi in a May 21, 1979 memorandum (CX 52), written when he was Treasurer and Vice President of AMI. (CX 12Z21) His memorandum estimated that if AMI calculated the cost basis of the assets based on their appraised value at the time of the acquisition, rather than the book value used by the previous owners, there would be an increase in Medicare reimbursement to French of over $8 million over the 30-year life of the assets. (CX 52A) AMI followed Mr. Takahashi's advice and by fiscal year 1981, the first full fiscal year after AMI's acquisition of French, was claiming a "cost basis" for French's assets (CX 712Z262) which corresponded to the value of those assets as appraised in 1979 (with adjustments for intervening purchase, construction, and disposal of assets). (CX 31Z5; CX 712Z83, Z202) This new "cost basis" was considerably greater than the book value of the assets in the hands of the previous owners. (CX 52A) While hospitals participating in the Medicare program are subject to limitations on reimbursable cost (42 C.F.R. 405.460 [1982]; RX 5828; Schramm, 2278–79; Derzon, 1997–2005, 2054–55; Lave, 947–48, 950), a fairly liberal standard is utilized which can be met by the average hospital. (*See* RX 5828)

34. Until recently, California's Medi-Cal program generally fol-

lowed Medicare reimbursement principles. (Derzon, 2005) Thus, the increase in Medicare reimbursement from the increased "cost basis" of French would be accompanied by a similar increase in Medi-Cal reimbursement. The Federal Government pays a certain percentage of the Medi-Cal reimbursement for those services eligible for Federal subsidy. (42 U.S.C.A. 1396b(a)(1), 1396d(b) (West Supp. 1982)) Those Federal payments are interstate payments. (CX 734A–B) [15]

F. *The Relevant Product Market*

35. General acute care hospitals offer a variety of health services in a single location. In California, to be a general acute care hospital, a facility must offer the following services on a 24-hour basis: medical, nursing, surgical, anesthesia, laboratory, radiology, pharmacy and dietary services. (*Cal. Health & Safety Code* Section 1250(a) [Deering 1982]; *see also* RX 5469Q) While some facilities may offer one or two services which hospitals offer, no other facility offers them all. (Steacy, 145–47; Lave, 882) The cluster of services offered by general acute care hospitals provides for the complete treatment of patients with a broad range of conditions. (Steacy, 146) Thus, the hospital offers a variety of facilities to help diagnose disease (Boyd, 330); it offers facilities for surgery (Boyd, 329–30); it provides nurses who work round-the-clock to carry out the orders left by the doctor and keep the doctor informed of any change in a patient's condition (Boyd, 330); it provides the nurses necessary to administer certain medications to a patient. (Bernhardt, 1281–82; *see also* Schwam, 565) Most importantly, hospitals provide the equipment and personnel to deal with unexpected, but potentially life-threatening, situations. (Boyd, 335; Schwam, 567–68) While a particular service may be available at some other institution, general acute care hospitals are unique in that they alone offer this whole cluster of services in a single setting. (Lave, 881–82)

36. There is a well-accepted definition of "acute care hospitals" used by health planning organizations, the American Hospital Association, and the State of California, including the California Health Facilities Commission. (Lave, 880–81) This definition draws a distinction between acute care and long-term hospitals and between hospitals and other providers of health care, such as doctors, clinics, and hospices. (Lave, 881) California statutes distinguish general acute care hospitals from other "health facilities" offering inpatient care, such as psychiatric and specialty hospitals, and skilled nursing and intermediate care facilities. "Health facilities" are further distinguished from "clinics" offering only outpatient services. (*Cal. Health & Safety Code* Sections 1200, 1250 [Deering 1982 & Supp. 1983]) Administrators of hospitals also use the term "general acute care hospi-

tals"; it is a term generally recognized in the industry. (Steacy, 143–44; Anderson, 235–36)

37. AMI's primary business is the owning and operating of general acute care hospitals; over 85 percent of AMI's revenues are derived from its operations of such institutions. (Reilly, 737; Weisman, 1712–13) Most important, AMI itself has recognized that its hospitals compete only with other general acute care hospitals. Included in one memorandum analyzing the French acquisition is a chart entitled "Competition—French [16] Hospital." It lists only the other four general acute care hospitals in the county. (CX 38M) In its study of AMI's competition in San Luis Obispo, Friesen International, Inc., an AMI subsidiary, analyzed only other general acute care hospitals. (RX 5435T–Z4) The administrator of Sierra Vista, in referring to his competition, mentioned only other general acute care hospitals. (Carlson, 1327–28)

38. It is "critically important" for doctors to have access to general acute care hospitals. (Schwam, 563; *see also* Boyd, 329; Bernhardt, 1284; Harvey, 1681) Surgeons, for example, require hospitals not only for the surgery itself, but also for the other support staff and services necessary to care for the patient before and after the surgery. (Anderson, 236; Boyd, 330) Only hospitals have the necessary equipment to perform major surgery. (Anderson, 236) Likewise, hospitals are often the only facilities able to perform certain sophisticated tests which doctors require. (Bernhardt, 1231; Schwam, 565)

39. A number of physical ailments can be treated safely only by admitting a patient to the hospital. (Anderson, 236; Boyd, 334; Schwam, 567–69; Bernhardt, 1231; Harvey, 1681) These situations include, among others, patients in need of certain kinds of surgery (Boyd, 334–35; Anderson, 236; Bernhardt, 1231), patients requiring certain diagnostic procedures (Bernhardt, 1231; Harvey, 1679–80), and patients in need of observation or around-the-clock monitoring. (Boyd, 333; Harvey, 1678–79) Almost any patient with acute cardiovascular disease must be admitted to the hospital for treatment. (Harvey, 1681) Patients in need of intravenous medication (Schwam, 568; Bernhardt, 1281–82); and those in need of intensive care services must be admitted to the hospital. (Schwam, 568–69) Also, patients having procedures which require general anesthesia usually will be admitted to the hospital. (Boyd, 332–33; *see* RX 5469Z172)

40. In a number of other situations it is possible to treat a patient without admission to a hospital, but several factors make this option unattractive. In those instances where nursing care is required, a patient could be treated at home only if private duty nurses were employed at great expense. (Boyd, 334, 336; Schwam, 567–68) Even if nurses were hired, it still might be necessary to admit a patient if

complications arose. (Boyd, 335) The risk of unexpected complications makes treating certain conditions on a nonhospital basis extremely risky. (Boyd, 334; Harvey, 1680) Treating other conditions outside the hospital would require a doctor to spend excessive amounts of time with a single patient, thus forcing the doctor to neglect others. (Schwam, 567–68) Finally, even when a patient could be treated at home, it would often be impossible [17] for the doctor to render the same standard of care to the patient as would be possible in the hospital. (Schwam, 567–68)

41. Certain categories of illness can be treated in either the hospital or in a nonhospital setting, such as the doctor's office or the patient's home. (Boyd, 332) However, whether a doctor treats a particular patient with such a condition in the hospital or outside of it will depend on the severity of the illness and whether some "predisposing condition" creating the risk of complications is present. (Harvey, 1677–78; Collins, 1449, 1463–64; Schwam, 564–66) In most instances, patients are admitted to the hospital only when they cannot be treated outside of it. (Boyd, 332; Bernhardt, 1281; Harvey, 1677) A number of factors prevent a patient who could be treated in a nonhospital setting from being admitted to the hospital. First, hospital utilization review and federal reimbursement regulations prevent doctors from admitting patients to the hospital unless it is medically necessary. (Derzon, 1970–71; *see* Stahl, 1381, 1392–93) Second, doctors prefer to have as few patients as possible in the hospital, since they do not wish to spend time unnecessarily making hospital rounds. (Harvey, 1678; *see also* Boyd, 340; Bernhardt, 1285) Third, patients prefer to be at home if possible, and often it is less expensive for a patient to be treated outside the hospital setting. (Bernhardt, 1240–41)

42. Respondents submitted a chart, RX 5794, which purports to show the number of inpatient surgeries performed at French and Sierra Vista which also could have been performed on an outpatient basis. This chart has some basic flaws. First, it does not show whether the patients had "predisposing conditions" which necessitated the procedure being done on an inpatient basis. (Collins, 1449, 1463–64, 1466–69) Second, the chart included as inpatients, patients admitted under Sierra Vista's "one-day stay" program, where patients do not stay in the hospital overnight. (Collins, 1460–61) Finally, there is disagreement concerning which procedures can safely be performed on an outpatient basis. For example, one of the lists upon which respondents' chart is based included heart catheterizations among procedures which could be done on an outpatient basis. (RX 5641Z37) However, a cardiologist testified in this proceeding that heart catheterizations can be done safely only on inpatients. (Harvey, 1679–80)

43. Some ancillary services, such as x-rays and lab tests, which are

rendered to inpatients also are available in a nonhospital setting. Some doctors' offices and clinics offer x-ray procedures and laboratory tests (Schwam, 599–600; Bernhard, 1232), and private labs also are capable of performing many tests. (Stahl, 1403; CX 452B) However, these nonhospital facilities are not used to treat individuals in need of inpatient care. When people needing inpatient care require such [18] services, they use the facilities present in the hospital. (Schwam, 566–67) Doctors never send inpatients out of the hospital for ancillary services when those services are available in the hospital. (Bernhardt, 1283; Schwam, 567)

44. General acute care hospitals also offer certain services which do not require a patient to be admitted to the hospital. Such services include tests, ambulatory surgery procedures, and some emergency room services. However, outpatient procedures account for only a small part of the activity of general acute care hospitals. In San Luis Obispo County, most hospitals derived no more than 13 percent of their adjusted gross revenues from such outpatient services, although SLO General received about 32 percent from such services. Only 7.5 percent of French's adjusted gross revenues were from outpatient services between 1977 and 1980. (CX 1062)

45. In only a few instances are the outpatient services provided by hospitals a substitute for those offered in a nonhospital setting. The most important outpatient service provided by a hospital is the hospital's emergency room. All hospitals in San Luis Obispo County offered full-time emergency room services. (*See* RX 5469Z88) In some cases, emergency rooms may treat relatively minor problems that probably could be treated in a doctor's office or a clinic. But patients often come to emergency rooms unaware of what is wrong with them, but aware that the full gamut of care is available to them at an emergency room. (*See* RX 5469Z70) Doctors' offices, which are not open 24 hours a day and cannot provide as broad a range of services as emergency rooms, are therefore not a substitute for a patient who believes he needs emergency care. A patient needing emergency care may use the emergency room because he does not have a regular doctor or is not readily knowledgeable about an available doctor.

46. Hospitals also offer facilities for outpatient surgery, which is surgery which does not require the patient to remain overnight. (Boyd, 333; Collins, 1446–47; RX 5469Z172) Outpatient surgery at hospitals is usually performed on patients who do not require a long period of observation. (Stahl, 1380; RX 5469Z177) Some minor surgery is performed in doctors' offices. (Boyd, 331–32) However, the surgeries done on an outpatient basis in hospitals are usually those procedures which cannot be done in a doctor's office. (*See* Collins, 1462–63) Also, some patients have tests or x-rays performed on an outpatient basis

at a hospital even though such procedures can also be done outside the hospital. (Bernhardt, 1235) When doctors have their own equipment outside the hospital, they do not use the hospital's equipment. (*See* Schwam, 566) For those doctors who do not have access to such facilities, **[19]** however, there is no substitute for the equipment available at the hospital. (Bernhardt, 1235)

47. In San Luis Obispo County the five hospitals are all general acute care hospitals. (Anderson, 235; Steacy, 144–45) While some other institutions offer some of the same type of services, none can offer the essential cluster of services offered by acute care hospitals. Certain diagnostic procedures and simple surgery can be done in physician's offices and clinics; however, no clinic or doctor can offer the full range of tests, especially the more sophisticated tests provided by a general acute care hospital (Schwam, 565), and a number of such procedures cannot be done in doctors' offices. (Boyd 333–34) In addition, no clinic can treat those conditions which require that patients be admitted to the hospital. (*See* F. 39)

48. Some procedures which are performed in hospitals can be done in "freestanding surgicenters." (RX 5812A–B) No such facility exists in San Luis Obispo County (Anderson, 238; Bernhardt, 1282), and it is unlikely that such a facility will be built. The Mid-Coast Health Systems Agency has noted that existing ambulatory surgical capability in the county's hospitals is currently underutilized, and would recommend that the necessary regulatory approval for such a facility be denied. (CX 1064 at VI–45 to VI–46; *see also* RX 5469Z174; RX 5821Z61–Z62) In addition, similar facilities such as birthing centers or freestanding renal dialysis centers, do not exist in San Luis Obispo County. (*See* Lave, 883)

49. The only inpatient psychiatric service offered in San Luis Obispo County is at SLO General, which has 14 beds set aside for psychiatric patients. (CX 1064 at V–64) These beds are licensed separately from the hospital's general acute care beds, and government approval would have to be obtained to shift those beds into service as general acute care beds. (Johns, 1877; *Cal. Health and Safety Code* Sections 437.10(a), 1250.1 [Deering 1982 & Supp. 1983]) Further, these psychiatric services are not considered to be general acute care services (Anderson, 303); the nature of the illness is fundamentally different from the physical illnesses treated in general acute care facilities, and the form of treatment prescribed is different. (Steacy, 147–48)

50. There are home health care services in San Luis Obispo County. These services send nurses periodically to the homes of patients who require continuing care. (Schwam, 600–01) Home health care services provide care only to patients near recovery from their illnesses. (Schwam, 604) They do not offer the round-the-clock care offered by

general acute care hospitals, nor can they perform surgical procedures or other tests. (*See generally* RX 5469Z318–Z327; Schwam, 600–01)

51. There is one hospice operating in San Luis Obispo County. (RX 5469Z332) This service "provides palliative and [20] supportive care to the terminally ill patients and their families." (RX 5469Z328) In San Luis Obispo County this service is provided to patients in their homes, not in a private facility. (RX 5469Z331–Z333) Furthermore, unlike general acute care hospital services, hospices are long-term as opposed to short-term services (RX 5469Z333–Z335), and the average census of the hospice in San Luis Obispo was only eight patients. (RX 5469Z335) Most importantly, hospices deal only with terminally ill people to give them comfort and rest as long as they survive. (RX 5469Z328) Thus, this service represents a substitute for only a minute portion of the services offered by a general acute care hospital.

52. For the bulk of services offered by general acute care hospitals, demand is relatively inelastic. A person who believes himself seriously ill will go to a hospital, rather than a nonhospital setting, regardless of the cost. Even in less extreme cases, there is little price or quality cross-elasticity of demand between hospital and nonhospital services. (Lave, 882–83)

53. As noted above, some tests and x-rays are available on an outpatient basis both in the hospital and in doctors' offices. (F. 43) In addition, to a limited extent, some surgical procedures could be performed in either a doctor's office or on an outpatient basis at a hospital. (F. 40–42) However, there is virtually no competition for the cluster of services or breadth of care offered by hospitals on an inpatient basis. "[T]here is a core of services which are not offered elsewhere. . . ." (Lave, 882) In other instances, treating the patient outside the hospital is especially dangerous since it raises the risk of complications. (F. 39–40) While there might be adequate sources for some outpatient services to substitute for those offered by the hospital should an increase in price or a reduction in quality occur, no similar substitutes for inpatient care exist. Even if the number of procedures done on an outpatient basis would increase, this would not change the unique nature of the essential core of services offered on an inpatient basis. As one doctor testified, "[C]learly there are some things that will always need to be done in hospitals and certain conditions that need to be treated in hospitals." (Bernhardt, 1283)

G. *The Relevant Geographic Markets*

54. The relevant geographic market defines the area within which market power could be successfully exercised. Determination of the market requires an inquiry into where people go when they need

hospitalization; and what alternatives are available in the event market power is exercised. It also [21] is relevant to look at the perceptions of people in the marketplace to determine the economic realities of the situation. (Lave, 888–89)

55. The origin of patients at hospitals is relevant in determining the relevant geographic market. (Lave, 886; Schramm, 2338) Ronald Rowe, an FTC staff accountant, at complaint counsel's request reviewed patient origin information by ZIP Code submitted by all the hospitals in San Luis Obispo County, plus those in King City (Monterey County) and Santa Maria (Santa Barbara County), and summarized this patient origin data in a series of charts, CX 614 through CX 621. (Rowe, 121–22) These charts showing the residence of patients admitted to hospitals in San Luis Obispo County are summarized in Appendix C. Each hospital in the county drew over 90 percent of its patients from within the county. Only a small percentage of patients came from areas outside the county. French had the highest number of patients from Santa Maria, but they amounted to only 4 percent of all of its admissions. Twin Cities, the only hospital in the North County area, drew only 1.6 percent of its patients from the neighboring county to the north, Monterey County.

56. AMI had concluded that the service areas of French and Sierra Vista were defined by the boundaries of San Luis Obispo County since 90 percent of their patients came from within the county. (CX 255C, F; CX 38Z7–Z8) AMI's wholly-owned subsidiary, Friesen, prepared three studies of AMI hospitals in San Luis Obispo County in 1980–81 and found that most of the patients at AMI's three hospitals were residents of the county. (RX 5435Z29–Z30; RX 5436Z30–Z31; RX 5437Z28–Z29) In addition, according to AMI's and Friesen's studies, few patients come to San Luis Obispo County hospitals from outside the county. (CX 255C; RX5435Z30; RX 5436Z31; RX 5437Z29) Friesen also concluded that the market of each hospital was limited to patients residing in the county or some portion thereof. For example, with regard to Sierra Vista, Friesen reported:

> *Current market definition:*
> Patients of the full range of medical specialties with primary and secondary illnesses and patients with trauma, rehabilitative needs and some tertiary illnesses who live in all parts of San Luis Obispo County.

(RX 5436Z51; *see also* RX 5435Z51; RX 5437Z47)

57. The extent to which residents of San Luis Obispo County leave the county for their hospital care, referred to as outmigration, is a relevant factor in determining whether the [22] county is the proper geographic market. (Lave, 886–88; *see* Schramm, 2340–45; Mittelstaedt, 1084) Outmigration may be due in large part to residents who

need hospitalization while away from the county, or to residents who leave the county to receive care not available in San Luis Obispo County. (Anderson, 240; Lave, 887; Schramm, 2388–89; F. 70)

58. The Health Care Financing Administration studied where Medicare beneficiaries, age 65 and over, were hospitalized. (CX 568) CX 568 summarizes where those residents of San Luis Obispo County who were Medicare beneficiaries over age 65 were hospitalized in 1977. It shows that 85 percent of these individuals were discharged from hospitals within the county.[6] These outmigration figures were subsequently kept on an Health System Agency (HSA) basis; for HSA 8, which contains San Luis Obispo County, the 1977 outmigration figure is approximately 14 percent, comparable to the county figure shown on CX 568C. (CX 582A) In 1978 and 1979, the outmigration from the HSA remained at about 14 percent. (CX 582B–C) There is no substantial evidence indicating that the experience of the Medicare beneficiaries is atypical. Dr. Schramm stated that since Medicare recipients were older and often retired, they might be less mobile (Schramm, 2344); however, on cross-[23]examination he also stated they might be able to travel more because they had more leisure time (and thus more likely to be hospitalized outside the county during travel). (Schramm, 2389)

59. Similar information also was prepared by the California Department of Health Services relating to the outmigration of Medi-Cal recipients. (CX 594A–C) Medi-Cal is the California program that pays for hospital care for certain indigent persons. (Bernhardt, 1299) CX 594C shows that about 87 percent of hospitalized San Luis Obispo County residents covered by Medi-Cal were discharged from hospitals in the county. (CX 594C)[7]

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[6] These figures are arrived at by adding up the percent of total discharges which took place at San Luis Obispo County hospitals as shown on CX 568C. Paso Robles District Hospital and Atascadero General Hospital were closed when the new Twin Cities hospital opened in 1977. (Schwam, 569–70) The percent discharged from hospitals outside the county is the difference between the total and 100 percent.

Sierra Vista Hospital	36.27%
Arroyo Grande Community Hospital	17.29
French Hospital	14.04
Twin Cities Hospital	11.71
San Luis Obispo General Hospital	4.57
Paso Robles District Hospital	.90
Atascadero General Hospital	.54
Total	85.32%
	100.00%
	-85.32
Percent discharged from hospitals located outside San Luis Obispo County.	14.68

[7] According to the Mid-Coast Health Systems Agency, the Office of Statewide Health Planning and Development (OSHPD) had determined in 1980 that some outmigration from the HSA was taking place. However, the OSHPD estimated that such outmigration amounted to only 5 percent of patient days. (CX 1064 at V–14)

60. AMI documents suggest that there is little outmigration from San Luis Obispo County. In discussing the service area of French Hospital, an AMI memorandum written prior to the acquisition of French noted that "[T]he population of SLO County is somewhat isolated from other health care facilities," and that the closest facilities outside the county, in King City and Santa Maria, "have less extensive facilities and are less convenient to most SLO County residents." (CX 38Z7) A Friesen chart, RX 5436Z1, prepared by Robert E. Mittelstaedt (a Friesen International, Inc. vice president and consultant to AMI—Mittelstaedt, 997) and his colleague Michael Brunelle (Mittelstaedt, 1189), calculates the market shares of AMI's three San Luis Obispo County hospitals for 1980. (Mittelstaedt, 1191) It concluded that AMI had 77 percent of the patient days attributable to county residents and that "23% of bed days are going elsewhere." (RX 5436Z1) Thus, 23 percent of the bed days were going to non-AMI hospitals, either within or without the county. (Mittelstaedt, 1192) The Friesen charts did not account for the market share of the two non-AMI hospitals within the county, SLO General and Twin Cities. (Mittelstaedt, 1192–93) Allowing a minimal market share for Twin Cities and SLO General, the outmigration would be substantially below 23 percent. (*See* Mittelstaedt, 1193)[8] [24]

61. According to charts prepared by Mr. Mittelstaedt for this litigation, approximately 30 percent of San Luis Obispo County residents requiring hospitalization were hospitalized outside the county (RX 5815A), and 23.5 percent of San Luis Obispo County and northern Santa Barbara County residents were hospitalized outside those areas. (RX 5802A) In order to determine the outmigration from San Luis Obispo County, Mr. Mittelstaedt took the rate at which the national population uses hospitals and adjusted it for the fact that California residents use hospitals at a rate equal to 72.8 percent of the national average. (Mittelstaedt, 1087; RX 5815C) He adjusted this figure for the age of the population to get the rate at which individuals within four different age groups were expected to use the hospital. (Mittelstaedt, 1088–89; RX 5815C) This "Adjusted SLO Rate Per 1,000" for each age group was then multiplied by the actual 1980 county population by age group to yield the expected patient days for San Luis Obispo County residents. (Mittelstaedt, 1088; RX 5815C) From the total expected patient days were substracted the actual number of patient days generated by San Luis Obispo County residents at hospitals in the county. (Mittelstaedt, 1094; RX 5815B) The difference

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[8] At the hearing complaint counsel pointed out that if SLO General and Twin Cities had only a 5 percent market share each, that would mean that only 13% of the patient days were leaving the county. (Mittelstaedt, 1193) Five percent may be low since, in 1978 and 1979, SLO General and Twin Cities had a combined share of inpatient days of county hospitals of approximately 24 percent. (CX 602) If these figures were similar for 1980 there would have been little outmigration from the county.

between these two figures was assumed to be the number of patient days leaving the county. (*Id.*) Similar calculations were made to reach the conclusion that 23.5 percent of patient days were leaving the larger area of San Luis Obispo County and northern Santa Barbara County. (Mittelstaedt, 1089–90; RX 5802)

62. Mr. Mittelstaedt's conclusions, prepared for this litigation (Mittelstaedt, 1184–85, 1197; *see also* Tr. 1179), are inconsistent with the conclusions of the Medicare and Medi-Cal charts, the estimates of the OSHPD, and the chart prepared by Friesen prior to the onset of this litigation. (F. 58–60) The figures arrived at by Mr. Mittelstaedt are based on estimates. (Mittelstaedt, 1180–81) In order to reach the conclusions expressed in RX 5802 and RX 5815, Mr. Mittelstaedt had to make a number of different assumptions with regard to the utilization of hospitals by San Luis Obispo County and northern Santa [25] Barbara County residents. (*See* Mittelstaedt, 1182–89) An actual figure, as opposed to an estimate, could have been arrived at had a different methodology been used. (Mittelstaedt, 1181) One assumption made by Mr. Mittelstaedt was that it was reasonable to use the California utilization rate as the rate at which residents of San Luis Obispo County and northern Santa Barbara County used hospitals. (Mittelstaedt, 1087–89) If residents of San Luis Obispo County used the hospital less than the California average, the number of expected patient days would be too high and the amount of outmigration would appear to be greater than it really is. (Mittelstaedt, 1186–87) CX 533 indicates that HSA 8, which contains San Luis Obispo County, has one of the lowest utilization rate of all HSAs in California, 684 patient days per 1000 population.[9] (CX 533C) In contrast, the California utilization rate used by Mr. Mittelstaedt in his charts was 843 per 1000, thereby overstating the amount of outmigration from the county. When Mr. Mittelstaedt's charts are recalculated using the utilization rates for the HSA they show an amount of outmigration consistent with other evidence in this case. They show that only 13.96 percent of the patient days generated by San Luis Obispo County residents were in hospitals outside San Luis Obispo County (CX 1001), and that 6.76 percent of the patient days generated by San Luis Obispo County and northern Santa Barbara County residents were in hospitals outside those areas. (CX 1002)

63. Mr. Mittelstaedt attempted to explain the discrepancy between the chart presented at the hearing, RX 5815, and the chart in the Friesen report (RX 5436Z1) by pointing to the fact that different population figures were used and that Friesen did not have information on non-AMI hospitals. (Mittelstaedt, 1193–94) However, Mr. Mittelstaedt admitted that he updated the population figures by

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[9] The utilization rate for HSA 10, which includes Santa Barbara County was also quite low, 711 per 1000.

contacting local officials (Mittelstaedt, 1190; RX 5436Z1), and that at the time the chart in the Friesen report was done he believed it was reliable. (Mittelstaedt, 1190) The fact that he did not have information on patient days at Twin Cities and SLO General does not affect the validity of the 23 percent figure. The additional information would merely show what portion of that 23 percent went to Twin Cities and SLO General. The remaining portion—some number less than 23 percent—then would be the outmigration from the county. (F. 60)

64. Although it is impossible to conclude the precise [26] amount of outmigration from San Luis Obispo County, the record suggests that it was between 5 percent and 14 percent. (F. 58–60) A certain amount of outmigration is expected since some people have no choice but to use hospitals outside the county. Some of these people may go to other areas for services not offered by the area hospitals (Harvey, 1660. F. 70), and some may need care while away from the county. With those exceptions, reliable evidence shows that people will not travel far when they need to be hospitalized. Most people will stay near their homes so they can be visited by their families. (Anderson, 240) When patients' families have to travel a great distance to see a patient in the hospital, it causes a major disruption in the whole family. (Harvey, 1661; CX 217Z11) Furthermore, since doctors usually admit to hospitals near their offices, unless patients travel out of the county to see a doctor, they will inevitably end up in a hospital near their homes. (F. 65–66; CX 217Z11)

65. The location of doctors' offices is a relevant factor in determining the geographic market. (Lave, 888) Nearly every admission to a hospital in San Luis Obispo County was made by a physician whose offices were located in the county. According to a chart introduced by complaint counsel, 99.7 percent of the admissions at the five hospitals in San Luis Obispo County during 1980 were made by physicians whose offices were located in the county. (CX 626) Out of over 22,000 admissions, only 74 patients were admitted by doctors whose offices were located outside the county. (*Id.*)

66. Complaint counsel presented a series of charts which showed the office location of those doctors with active privileges[10] at the hospitals in San Luis Obispo County, Santa Maria, and King City. Most admissions to the hospitals in San Luis Obispo County are made by doctors with active privileges. (Rowe, 115–120; CX 629–CX 633) Virtually all of the admissions made by doctors with active privileges at San Luis Obispo County hospitals were by doctors with offices in the county. Neither Sierra Vista, SLO General, Twin Cities, nor Ar-

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[10] A doctor with active privileges at a hospital can admit an unlimited number of patients to that hospital at his discretion. Other privileges limit the number of patients that a doctor can admit. (Schwam, 560–61)

royo Grande had a single patient admitted by an active staff doctor whose office was located outside the county. (CX 629; CX 631–633) 1.5 percent of French's admissions by doctors with active privileges were made by two doctors whose offices were located in Santa Maria. (CX 630) Only one doctor with an office in San Luis [27] Obispo County held admitting privileges at any of the three closest hospitals outside the county. Neither Valley Community Hospital in Santa Maria, nor George L. Mee Memorial Hospital, in King City, had any patients admitted by active staff doctors whose offices were in San Luis Obispo County. (CX 635; CX 636) Marian had one out of ninety-five doctors with active privileges who had an office in San Luis Obispo County. (CX 634) In 1980 this doctor admitted less than one percent of all the patients admitted to Marian Medical Center. (CX 124B; Steacy, 152–53)[11]

67. The perception of those who work in a market also is a relevant factor in determining the geographic market. (Lave, 888–89) Officials of AMI concluded that San Luis Obispo County represented a distinct service area. (CX 255F; F. 56) A chart contained in an internal memorandum analyzing the French acquisition entitled "Competition—French Hospital," gives the owners and occupancy of those hospitals that presumably were viewed as competitors of French. The chart discusses only the four other hospitals located in San Luis Obispo County. (CX 38M) Friesen also concluded that the market for each hospital was limited to the county or some portion thereof.[12] (RX 5436Z51; RX 5435Z51; RX 5437Z47)

68. The administrator of French Hospital from June 1972 until July 1979, when it was acquired by AMI, testified that French's principal competitors were the other hospitals in the city of San Luis Obispo. (Anderson, 220) Hospitals outside the county were not viewed as competitors. (Anderson, 228) Efforts to attract patients were not directed outside the county because [28] it was believed that there was little hope of getting patients from those areas. (Anderson, 229)

69. Mr. Steacy, the Executive Vice President of Marian Medical Center in Santa Maria for the past seven years, stated that his only competitor was Valley Community Hospital, the only other hospital in Santa Maria. (Steacy, 149–50) The hospitals in San Luis Obispo County were not competitors because they had different medical

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[11] This doctor also practiced at Arroyo Grande Community Hospital in San Luis Obispo County. (Steacy, 152)

[12] The Friesen reports do make reference to the Santa Maria hospitals in the "Competition" section; however, it is unclear if this is intended to mean that the Santa Maria hospitals were currently competing with San Luis Obispo County hospitals. Friesen states that Arroyo Grande will face increasing competition from Santa Maria hospitals "if the potential Vandenburg expansion, [*i.e.*, around Vandenburg Air Force Base in northern Santa Barbara County] takes place causing growth in Northern Santa Barbara County and south San Luis Obispo County." (RX 5435T) In fact, in the Arroyo Grande plan, Friesen noted with regard to the Vandenburg development, "there is currently little evidence . . . to indicate that any significant impact will be felt in the next three to five years." (RX 5437Z48; *see also* RX 5437C)

staffs and served different communities. (Steacy, 150–51) Mr. Steacy attempts to keep track of rates at Valley Community Hospital (Steacy, 149), but does not keep track of rates at Arroyo Grande, the hospital in San Luis Obispo County which is closest to Marian. (Steacy, 150) This view is corroborated by other evidence in the record. As complaint counsel's charts show, few patients from the Santa Maria area travel to hospitals in San Luis Obispo County. (F. 55) Other evidence showed that the majority of patients at Santa Maria hospitals came from the northern Santa Barbara County area. (CX 619–20; CX 570U) Valley Community Hospital in Santa Maria drew 90.4 percent of its patients from northern Santa Barbara County area in 1980, and 9.4 percent from San Luis Obispo County. (CX 620) In 1980, Marian Medical Center drew about 86.6 percent of its patients from Northern Santa Barbara County and 11.4 percent from San Luis Obispo County. (CX 619) Most patients who come to Santa Maria hospitals from San Luis Obispo County, are from areas in the extreme southern portion of the county. (CX 619–20) Over half of these patients are from Nipomo, a town close to the county border which accounts for only 3.4 percent of the population of San Luis Obispo County. (U.S. Department of Commerce, Bureau of the Census, [*1980 Census of Population, General Population Characteristics—California* 6–31, 6–34, 6–36, 6–40])

70. Testimony of doctors in the community supports the view that the county is a separate market. Specialists who received patients through referral stated that most doctors that refer patients to them are located in San Luis Obispo County. (Boyd, 343–44, Schwam, 572; Harvey, 1637) Furthermore, it is very rare for doctors in the county to refer patients to doctors outside the county. When it is done, it is usually patients with unusual medical problems who are referred to major medical centers in the Los Angeles or San Francisco areas, and at Stanford University. (Anderson, 258–60; Boyd, 346, 423–24; Bernhardt, 1253–54, 1286–87; Schwam, 473–74; Harvey, 1660–61)

71. It is relevant to determine if the city of San Luis Obispo is a market or submarket for the purpose of determining the possible anticompetitive effects of AMI's acquisition of French Hospital. (*See* Lave, 889–90; Complaint ¶¶ 12, 16) There are three separate areas in the county: the North County, the South County, and the Central/Coastal Area, which includes the city of San Luis Obispo. (F. 13–15) The physicians in each **[29]** area are served by a separate hospital or group of hospitals: Twin Cities serves physicians with offices in the North County; Arroyo Grande serves those in the South county; and French, Sierra Vista and SLO General serve those in the Central/Coastal area. (F. 75–77)

72. AMI has recognized for some time that three such areas existed.

The administrator of Arroyo Grande urged AMI officials to have health planning officials declare the South County area served by Arroyo Grande "a separate and distinct service area." (CX 187C) When AMI sought approval for 39 additional beds for Arroyo Grande in the early 1970's, AMI's administrator of the hospital wrote to health planning authorities that three distinct service areas existed. He stated:

> It is my strong feeling that the county needs to be divided into three health care service areas; one being the north part of the county, one the central part of the county, encompassing San Luis Obispo and the third area is the south portion of the county from Shell Beach to the Santa Maria River.

(CX 188; *see also* CX 192J; CX 187C; CX 197N; Schwam, 582–83) The health planning authorities agreed with AMI and designated three separate areas within the county for health planning purposes. (CX 217Z11–Z12) In September 1978, members of Mr. Loftin's staff (an AMI vice president) performed a long-range planning study of Arroyo Grande which indicated that Arroyo Grande was in a separate geographic market. (CX 197; *see* Loftin, 1492) That report noted that there is a "definite philosophical separation between the northern and southern portions of the county." (CX 197D; *see also* CX 197N) Moreover, AMI officials recognized that because of its geographical isolation, Arroyo Grande did not face any substantial competition. The report stated:

> It is important to reiterate that our findings clearly pointed to the fact that there is no definable competition for Arroyo Grande Community Hospital. The hospitals south of Arroyo Grande are geographically located too far away to be competition and the facilities, Sierra Vista and French and County, in the north likewise are geographically too far away to be considered direct competition . . .

(CX 197N) **[30]**

73. AMI also viewed the North County as a separate market. When it sought the right to build a new hospital in Templeton, AMI stated that the proposed facility would serve a distinct area in the northern section of the county. (CX 198B; CX 201 at 22, 28) Furthermore, even though the proposed facility would duplicate some services offered in the city of San Luis Obispo, such duplication was justified, according to AMI, because of the geographical isolation of the North County area. (CX 201 at 33–34)

74. Other witnesses testified that there were three submarkets within the county. (*See* Lave, 889–90) The former administrator of French Hospital who is current administrator at Twin Cities, Mr. Anderson, stated that when he was at French he regarded Sierra Vista and, to a lesser extent, SLO General as his competition for

patients and physicians. (Anderson, 220) Neither Twin Cities nor Arroyo Grande were viewed as competition because they were too far away and served a distinct medical staff and community. (Anderson, 227–28) Furthermore, Mr. Anderson stated that in his current capacity as administrator at Twin Cities, efforts are not made to attract patients to Twin Cities from the city of San Luis Obispo because it is unreasonable to expect patients to travel to Twin Cities for services available in San Luis Obispo. (Anderson, 239)

75. It is the doctors who admit patients and the evidence indicates that doctors usually admit where it is most convenient for them. (*See* Bernhardt, 1237) Thus, competition among hospitals for doctors tends to be concentrated in the area around the hospital. In San Luis Obispo County, doctors in the North County admit to Twin Cities, doctors in the South County admit to Arroyo Grande, and doctors in the city of San Luis Obispo admit to either French, Sierra Vista or SLO General. A series of charts prepared by Mr. Ronald Rowe, an FTC staff accountant, show that most patients at hospitals in the city of San Luis Obispo were admitted by physicians whose offices were located in the city or the nearby towns of Morro Bay, Los Osos, and Baywood Park. According to these charts 97.7 percent of all of Sierra Vista's admissions were made by physicians with offices in these four communities. (CX 622) A similar percentage, 97.5 percent, of French's admissions came from doctors in the same areas (CX 623), and 98.2 percent of SLO General's admissions were from physicians in these areas. (CX 624) Overall, 97.8 percent of all admissions to the three hospitals in the city were made by doctors with offices in one of these four communities. (CX 622–24)

76. Few doctors with offices in San Luis Obispo admitted patients to either Arroyo Grande or Twin Cities. At least 97 percent of the admissions at Twin Cities in 1980 were made by physicians with offices in the nearby cities of Templeton, Atascardero, and Paso Robles. (CX 632) One doctor on the [31] active staff at Twin Cities did have an office in the city of San Luis Obispo, but he admitted only .9 percent of all of Twin Cities' patients. During that same period, no active staff physician with an office in the South County admitted patients to Twin Cities. (CX 632) Similarly 91.7 percent of Arroyo Grande's admissions were from doctors with offices in the South County area near the hospital. Only about 7 percent of the hospital's admissions were by doctors in the city of San Luis Obispo. (CX 633) Thus, each hospital served a distinct group of doctors whose offices were uniformly located near the hospital to which they admitted patients.

77. It is difficult for doctors to use hospitals which are located at a distance from their offices. Doctors see their patients in the hospital at least once a day; therefore, if doctors whose offices were located in the city of San Luis Obispo tried to use Arroyo Grande or Twin Cities

they would spend too much of their time traveling between their offices and the hospital. (Boyd, 340; CX 197N; *see also* Bernhardt, 1228–29) Doctors who often need to see patients in emergencies could not do so if they had to travel 30 minutes to the patient. (Harvey, 1682–83) In short, the distance to Arroyo Grande and Twin Cities "curtail[s] absolutely expert and good medical supervision and care of . . . patients." (Harvey, 1682) Finally, few of these doctors expected to move their offices from their present location to use these other hospitals. (RX 5435Z16)

78. According to complaint counsel's charts, the largest proportion of patients admitted to the three hospitals in the city of San Luis Obispo were from the city itself or surrounding areas. During calendar year 1980, 51 percent of Sierra Vista's patients were from the three ZIP Codes encompassing San Luis Obispo, Morro Bay, and Los Osos. (CX 614) About 45 percent of French's patients and about 42 percent of SLO General's were from the same three areas. (CX 615; CX 616; *see also* RX 5435Z30)

79. The hospitals in the city of San Luis Obispo attracted a number of patients from the North and South County. For example, in 1980, about 41 percent of Sierra Vista's patients came from these areas. (CX 614) About 44 percent of French's patients and 51 percent of SLO General's came from these areas. (CX 615; CX 616) These patients were coming to the city to see particular doctors who were located in the city (RX 5435Z38; RX 5436Z41; Anderson, 241) and who, as noted above, tend to admit most of their patients to hospitals in the city. (F. 76) Thus, these patients cannot make use of hospitals outside the city unless their doctors move offices, which most did not expect to do (RX 5435Z16), or unless the patient selects a new doctor. **[32]**

80. There was little outmigration of residents of the city of San Luis Obispo to either Twin Cities or Arroyo Grande for hospital care. Those hospitals relied almost exclusively on patients from their own areas. Eighty percent of Twin Cities' patients were from the towns of Paso Robles, Atascadero, and Templeton alone; ninety percent were from nine towns which health planners identified as being in the North County area. (CX 617; CX 217Z12) Less than one percent of Twin Cities' patients came from the city of San Luis Obispo and the surrounding area. (CX 617) Likewise, most of Arroyo Grande's patients came from the South County area. In 1980, 89 percent of its admissions came from this area. (CX 618) The city of San Luis Obispo and the surrounding area accounted for less than two percent of its admissions. (CX 618)

81. Respondents contend that the concept of a relevant geographic market cannot readily be applied to the circumstances of the hospital industry generally or, in particular, to San Luis Obispo. (RPF 8.1) If

the determination of a relevant geographic market is undertaken, respondents argue the most appropriate approximation is the San Luis Obispo County/Northern Santa Barbara County region. (RPF 8.4, 8.10) Dr. Schramm, respondents' economic expert, stated with regard to defining relevant markets, "it strikes me as inappropriate to think about this case in those terms." (Schramm, 2336) If forced to define a market, however, Dr. Schramm would define it as San Luis Obispo County and the northern part of Santa Barbara County. (Schramm, 2337) Dr. Schramm stated that one basis of his opinion was evidence concerning the service areas of the hospitals, which he said "links to the idea of patient origin," and that "hospitals in Santa Barbara County also experience a good deal of transfer of patients who come in from San Luis Obispo County." (Schramm, 2338; *see* F. 69) Dr. Schramm also suggested that the proximity of the towns in the area to each other and the fact that Highway 101 connects them was relevant to his opinion regarding the geographic market. (Schramm, 2339) "The fact that there is a county line in there is largely irrelevant." (*Id.*)

82. There is little evidence to support Dr. Schramm's position. First, Dr. Schramm in his market analysis ignored the location of doctors' offices and their patient admitting practices. Second, studies of the service areas of the San Luis Obispo County hospitals, several of which were done by AMI, conclude that the service areas of the hospitals in San Luis Obispo County were limited to the county. (*See, e.g.,* F. 56) The former administrator of French Hospital testified that his primary competition was other hospitals in San Luis Obispo County. (Anderson, 228) Mr. Steacy, an official from Marian Medical Center hospital located in northern Santa Barbara County, testified he did not compete with hospitals within San [33] Luis Obispo County. (Steacy, 149–51) Only a small percentage of patients admitted to Santa Maria hospitals in Northern Santa Barbara County come from San Luis Obispo County, and nearly all of those patients came from communities in the extreme southern portion of the county. (*See* CX 619, CX 620, F. 69) To the extent there has been outmigration of patients from San Luis Obispo County (*see* F. 57–64), evidence demonstrates that Northern Santa Barbara County hospitals received only a portion of that patient load. (*See* F. 69)

83. The only other testimony which suggests that Santa Maria hospitals should be included in the geographic market was adduced from Mr. Carlson, the administrator of Sierra Vista, an employee of AMI. Mr. Carlson stated that, in his opinion, all the hospitals in San Luis Obispo County and northern Santa Barbara County were competitors of Sierra Vista. (Carlson, 1327–28) He defined competitors as "those hospitals [that] have the potential of attracting physicians who

in turn would admit patients from the same area that we serve." (*Id.*) Mr. Carlson's testimony conflicts with testimony of doctors to the effect that they could not practice both in San Luis Obispo and in outlying areas. One doctor stated that it is difficult to take care of the patients when distances are involved. (Harvey, 1682) Indeed, in 1980 Sierra Vista did not have a single patient admitted by an active staff physician with an office in Santa Maria. (*See* F. 66)

H. *Barriers To Entry*

84. A state "certificate-of-need" is required (except in exceptional circumstances) in California for any project involving any of the following, among other things:

a) Construction of a new hospital;

b) Addition of beds to an existing hospital (except for the expansion of a hospital's bed capacity by 10% or 10 beds, whichever is less, not more than once every two years, by a hospital with an occupancy rate over 85%);

c) Conversion of some or all of a hospital's beds from one bed classification to another (with limited exceptions); or [34]

d) Any capital expenditures by or for a hospital of more than $600,000.[13]

(*Cal. Health & Safety Code* Sections 437.10, 437.11(b)(4) (Deering 1982 & Supp. 1983)) Should Congress repeal, allow to terminate, or deny funding for implementation of the National Health Planning and Resources Development Act, as amended (42 U.S.C.A. 300k–1 to 300n –5 (West Supp. 1982)), the state of California will continue to require certificates-of-need for all of the projects described above, except that the threshold for certificate-of-need review of equipment purchases and capital expenditures not otherwise subject to review will be increased. (*Cal. Health & Safety Code* Sections 437.6(f), 437.10(a),(e) (Deering 1982 & Supp. 1983))

85. Applications for certificates-of-need are reviewed both by the state Office of Statewide Health Planning and Development (OSHPD) and local Health Systems Agencies (HSAs). (RX 5821M, Q, V–W; Johns, 1879–82) The applicant must first notify the HSA in its area and the OSHPD of its intention to file an application; 60 days after that notice is given, the application may be filed with the OSHPD and the HSA. (RX 5821Z10–Z14; Johns, 1880) The HSA reviews the application after a public hearing, and makes a recommendation on the application to the OSHPD, which then conducts it own public hearing and decides whether to grant or deny the application. (Johns, 1880–81) Should the applicant or the HSA be dissatisfied with the decision of the OSHPD, either party can appeal to the Advisory Health Coun-

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[13] This threshold will be adjusted periodically for inflation. (*Cal. Health & Safety Code* Section 437.10(e) (Deering Supp. 1983))

cil; should the applicant wish to appeal the Council's decision, it can take the matter into the courts. (Johns, 1881; RX 5821P, Z25–Z26)

86. A certificate-of-need application can be granted only if the project for which a certificate-of-need is sought will meet an unmet community need identified in the Statewide Health Facilities and Services Plan developed by the OSHPD, and meets other criteria, including the following: "The project will not adversely affect the utilization of other facilities offering the same or similar services in the service area." (RX 5821Z43–Z44; Johns, 1876, 1880–82) HSAs, in making their recommendations on certificate-of-need applications, are bound by the same criteria. (Johns, 1880) The purposes of the certificate-of-need process include discouraging the creation of excess capacity and duplicative services, and instead **[35]** channelling investment into facilities and services that meet identified needs of the community. (Johns, 1879, 1883)

87. There is considerable excess capacity in the general acute care hospitals in San Luis Obispo County. (RX 5835) Thus, it is unlikely that any proposal for an additional hospital, or additional hospital beds, in San Luis Obispo County could meet the criteria for approval of a certificate-of-need. (RX 5821Z43–Z44) The Mid-Coast Health Systems Agency has a policy of recommending denial of any application for addition of new hospital beds in areas with excess capacity. It estimates that San Luis Obispo County will have, for the rest of the decade, over 100 hospital beds more than what will be required for the care of county residents (including capacity to handle random fluctuations in hospital utilization). (CX 1064 at V–28 to V–30; F. 199) AMI has acknowledged that regulatory approval of new beds in the area is unlikely. (*See, e.g.*, RX 5435U; *see also* Reilly, 1795)

88. If new hospital beds were to become necessary in San Luis Obispo County, it is more likely that an existing hospital would be granted permission to add beds than that a new hospital would be approved. The certificate-of-need process is more effective in forestalling new entry into a hospital market than in blocking expansion of existing hospitals; in any event, opposition to a new facility by existing hospitals might significantly delay new entry. (Lave, 843, 875; *see also* RX 5854H, P, V; RX 5855J–K; RX 5856B–C)

89. The state government requires hospitals to meet detailed and extensive standards relating to the quality of care received by patients, including standards for facility construction, sanitation, and the range of services offered. (*See, e.g.*, 22 *Cal. Admin. Code* Sections 70201–70279, 70801–70865 (1979)) In order to treat Medicare or Medi-Cal patients on a nonemergency basis, hospitals must meet similarly detailed and extensive standards. (42 C.F.R. 405.1011–1235 (1982)) The Joint Commission on the Accreditation of Hospitals (JCAH), a

private organization, also imposes comprehensive standards on the hospitals it accredits. (Schramm, 2276) The result of these standards is to force hospitals to provide a "fairly high minimum level" of service from the start (*see* Lave, 825), and thus to deny a new entrant into the San Luis Obispo hospital market the opportunity to begin operations with a relatively small investment and then later build its operations up to a level comparable to its competitors' operations after obtaining a foothold in the market. **[36]**

90. The San Luis Obispo area has a great deal of excess bed capacity. (RX 5835; *see* RPF 3.7–3.20; F. 199) In addition, it has relatively few major unmet needs for specialized hospital services. (RX 5435Z11) It is unlikely there will be a *de novo* entrant into the hospital market in San Luis Obispo County in the foreseeable future. (*See* Reilly, 739)

I. *Competition in the Hospital Market*

91. Americans spent approximately $286 billion, constituting 9.7 percent of the gross national product, for health care in 1981. Approximately 41 percent, or $118 billion, of those expenditures were for hospital care. By contrast, in 1960, Americans spent approximately $12.7 billion on health care, of which only 33.6 percent was for hospital care. In 1975, expenditures for hospital care were approximately $52.1 billion. By 1981, they had increased to approximately $118 billion. (U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States 1982*, pp. 102, 418)

92. Congress recognized in 1974 that the health care industry does not respond to classic marketplace forces:

> [T]he health care industry does not respond to classic marketplace forces. The highly technical nature of medical services together with the growth of third party reimbursement mechanisms act to attenuate the usual forces influencing the behavior of consumers with respect to personal health services. For the most part, the doctor makes purchasing decisions on behalf of the patient and services are frequently reimbursed under health insurance programs, thus reducing the patient's immediate incentive to contain expenditures.

S. Rep. No. 1285, 93d Cong., 2d Sess. 39 (1974), *reprinted in* 1974 U.S. Code Cong. & Ad News 7842 at 7878.

93. A significant market feature in the hospital industry is that price plays a less significant role as a competitive variable than in most other industries. Most all transactions for hospital services are covered by third-party financing arrangements. (Derzon, 1978; Friedman, 1581; Loftin, 1515–16) With the advent of Medicare and Medicaid, "the vast majority of patients in the hospital were covered by insurers, third parties **[37]** and on a cost reimbursed basis." (Lave, 842; *see* Schramm, 2268) Respondents contend that 65 percent of

French's revenues and 65.8 percent of Sierra Vista's revenues in 1982 were paid by Medicare, Medi-Cal and Blue Cross based on costs. (RX 5813A, B) The remaining 35 percent of revenues came from patients who paid charges, and most of these were reimbursed by private insurers. (RX 5813A, B) Complaint counsel's figures for 1981 show the following: Sierra Vista - Medicare, Medi-Cal and Blue Cross 57.2 percent, others 42.8 percent; French - Medicare, Medi-Cal and Blue Cross 53.8 percent, others 46.2%. (CX 1033) The effect of third-party payment is to render patients somewhat insensitive to the prices charged for hospital services (Schramm, 2268–69; RX 5714K), although consumers, predictably, do from time to time express an interest in hospital charges, and are beginning to become more concerned about such charges. (*See, e.g.*, Schwam, 579–80) The evidence is clear, however, that patients seldom choose among hospitals based on their prices. (Derzon, 1982–83; Lave, 917–18; RX 5752; Friedmann, 1581–82; Loftin, 1485, 1515–16; *see* Harvey, 1639–40; Bernhardt, 1238–40) Under private insurance, Medicare, and Medi-Cal, neither the patient nor the physician is under financial pressure with respect to hospital charges. (Lave, 929)

94. The largest third-party payor is the federal government's Medicare and Medicaid programs. State governments, via their share of the Medicaid program, are also significant purchasers of hospital care. Through the traditional system of city and county hospitals, local governments also function as third-party payors. (Derzon, 1977–78; *see* F. 132) The next largest third-party payors are nongovernmental insurance organizations. The largest of these is Blue Cross. Following Blue Cross in terms of magnitude of hospital services purchased are commercial insurance carriers. (Derzon, 1977–78; *see* F. 30) The least significant purchasers of hospital care are individual consumers without insurance. These people are called "self-pay" patients. (Derzon, 1977–78)

95. Each year the Health Care Financing Administration ("HCFA"), the group within the Department of Health and Human Services ("HHS") which administers Medicare and Medicaid, produces figures on the proportion of nationwide hospital bills paid by third-party payors. About 55 percent of hospital costs are borne by the government at all levels. Former HCFA administrator Robert Derzon testified that the most recent set of figures for the proportion of hospital bills borne by all third-party payors combined is "somewhere around 90, 91 percent, possibly 89 percent." (Derzon, 1978) [38]

96. Medicaid and Blue Cross provide full coverage for hospital services. (Guy, 646; Lave, 964–65) Some third-party payors, however, provide for a "deductible" or require a "copayment." A deductible is a sum which the patient must pay "out-of-pocket" before the third-

party payor will begin to pay for medical care. A copayment is an arrangement under which the insured must pay a certain percentage of the bill for his medical services. (Schramm, 2292–93) Scientific studies of the behavior of consumers faced with these provisions show that a consumer facing a high deductible or copayment will use less medical care than he otherwise would. (Lave, 917) Insurance deductibles and copayments are increasing, causing consumers to be more price conscious. (Lave, 846–48; Schwam, 579–80) Dr. Lave also testified that he knew of no empirical studies which show that deductible or copayment provisions affect patient or doctor choice of hospitals. (Lave, 915)

97. Another significant feature affecting competition in the hospital market is that the largest third-party payors—Medicare, Medicaid and Blue Cross—do not pay on the basis of hospital charges; rather, these payors reimburse hospitals on the basis of costs. (Loftin, 1494–95; Derzon, 1994–95; *see* Steacy, 194) Thus, a cost reimbursed hospital increases its revenue by spending more. (Schramm, 2269; RX 5714K) The result of incurring fewer costs is revenue reduction. (Anderson, 291)

98. Because most patients come into contact with the system so infrequently and because of the rapid technological advances in this field, the consumer lacks information about his own need for medical care, and about the appropriateness of the care he receives. (Schramm, 2271–73) Thus, it is the doctor who makes the basic decisions about the course of care. (Lave, 936, 970; RX 5733D; *see also* RX 5731Q; RX 5714K) Both patients and doctors do not have complete knowledge about the prices of the care which is sought. (Derzon, 1982–83; Loftin, 1515–16) Partly, this is because the pricing of hospital services involves thousands of individual items. (Derzon, 1982–83) More importantly, consumers and doctors lack an incentive to become aware of exact prices because they know that third-party payors will pay the vast majority of the bill. Thus, doctors do not "price shop" for their patients. (Derzon, 1982–83; *see also* Loftin, 1515–16) Dr. Boyd, called by complaint counsel, testified that he does not consider the price of hospital services when he decides what hospital to admit a patient to:

> As far as where I'm going to hospitalize the patients, it really doesn't enter into my decision-making because at the present time, since I am not involved in any review activities on hospital bills, I really don't know about hospital charges.

(Boyd, 359–60) **[39]**

99. The financial survival of hospitals depends on their ability to earn revenues by filling their beds with patients. (Lave, 844) Excess

capacity in the hospital industry, compounded by the recession and other factors, has forced hospitals to take competitive actions such as advertising, recruiting physicians to join their staffs, and some price-cutting for particular services to try to fill empty hospital beds. (Lave, 823, 844–45) This competition between hospitals exists even though the hospital industry is subject to significant governmental and private regulation. (*See* RPF 2.20–2.35) Except in some states (not including California), the government does not control hospital charges. (Derzon, 2183; Schramm, 2372) The extensive regulation of the quality of hospital services that keeps that quality at least at a fairly high minimum level (Lave, 825) does not foreclose competition to provide even better services to patients. (*See, e.g.*, F. 101–02) Certificate-of-need regulation of competition in the area of capital expenditures does not suppress competition, but rather channels competition into other areas (Lave, 842–43), such as price and service improvements (CX 1050X), and also spurs competition for certificates-of-need. (*See* F. 124)

100. Mr. Robert A. Derzon, one of respondents' expert witnesses, was co-director of a project conducted by the consulting firm of Lewin & Associates to compare the economic performance of investor-owned and not-for-profit hospitals. (Derzon, 1938, 2081) CX 1030, "The Lewis Report", is the third volume of that study, entitled "Two Case Studies of Competition Between Hospitals". It was published in 1981. (Derzon, 2081; CX 1030 at inside title page) The Lewis Report is based on case studies of two different communities, each of which was initially served by a single non-profit hospital, but which became two-hospital towns with the entry of a new hospital operated by an investor-owned group. (Derzon, 2083–84) The report maintained the confidentiality of the participants in the case studies by using fictitious names. (Derzon, 2084) Names and other details were changed to disguise the location of the communities studied. Some quotations are composites of statements made by several individuals, but the information presented is otherwise factual. (CX 1030 at i) One of the communities studied was called "Cherokee", the existing non-profit hospital there was called "Houghton Memorial Hospital," and the new investor-owned hospital was called "Magnolia General Hospital." (CX 1030 at 1.4) The other community, "Lee County," was initially served by non-profit "Tanzer Memorial Hospital," and later by for-profit "Fort Benedict General Hospital." [40] (CX 1030 at 1.5) The report studied the issue of competition between hospitals through these case studies of what happened when a for-profit hospital entered a market previously served by a single non-profit hospital. (CX 1030 at i) Mr. Derzon participated in selecting the communities to be studied, helped determine what questions his staff should ask and what data they should obtain, super-

vised the writing of the report in its entirety (in conjunction with the president of Lewin and Associates), reviewed the work, and edited those parts he felt to be objectionable or inaccurate. (Derzon, 2082–83, 2089, 2098–99)

101. Doctors are the persons who admit patients to a hospital. Therefore, hospitals "compete for the affection and attention of physicians . . . because physicians bring them patients." (Derzon, 1981; *see* Lave, 826; Mittelstaedt, 1030; F. 102–105) Hospitals compete for physician patronage by offering the kind and quality of services and support personnel desired by physicians. (Lave, 826–27) An example of this strategy is the "Selective Centers of Excellence Strategy" proposed by AMI subsidiary Friesen, and adopted by AMI management, for AMI's Brookwood Medical Center. (CX 1060L) This plan called for the development of OB/GYN, oncology, cardiovascular surgery, and private psychiatry—specialties in which Brookwood already provided high-quality services—into "premier" services that would attract physicians away from competing hospitals. (CX 1060I) Friesen anticipated that the "premier" OB/GYN service would attract dissatisfied physicians from Brookwood's major competitors. (CX 1060–O–P)

102. Other examples of how hospitals seek to use new or better services in competing for physicians' patronage are reported in the Lewin Report. (CX 1030) "Tanzer Memorial Hospital" sought to forestall creation of a competing hospital by dissident physicians on its medical staff by beginning planning for an intensive care unit. (CX 1030 at 2.11) The dissident physicians proceeded to open a new hospital because, in the words of one dissident, Tanzer's board and administrator "were not thinking about modern medicine," and provided "second-rate" medical care. (CX 1030 at 2.11) When the new hospital was established, Tanzer made service additions of the sort desired by specialists. (CX 1030 at 2.33)

103. Hospitals also seek to attract physicians through purchasing hospital equipment desired by physicians and needed by their patients. (Lave, 826; Schramm, 2299) The ability of physicians to obtain the equipment they need at a hospital influences where they admit their patients. (*See, e.g.*, CX 1030 at 3.12–3.13; F. 135–138) In addition, hospitals [41] attempt to provide a favorable working environment for physicians. That was a major strategy of the for-profit "Magnolia Hospital" studied in the Lewis Report. Magnolia provided physicians with spacious, quiet, and well-lit physician dictation and chart review areas, which contrasted with a general lack of quiet space for doctors at its non-profit competitor. (CX 1030 at 3.6) Magnolia also assigned blocks of operating room time to its most active surgeons, so that the surgeons could minimize preparation time and work with nurses

familiar with their procedures. This policy was responsive to the complaints of surgeons about the "first come, first served" rule for scheduling operations at Magnolia's non-profit competitor. (CX 1030 at 3.10–3.11)

104. Hospitals also attract physicians by offering them financial incentives to shift their practices. Friesen recommended that AMI's Memorial Hospital of Tampa pursue this strategy by recruiting physicians and offering them subsidized office space. (CX 1055B) The Lewin Report also discussed hospitals' use of loans, subsidized office space, and income guarantees for physicians as competitive strategies. (CX 1030 at 1.14–1.15, 1.19, 2.13, 2.15, 3.9–3.10) Finally, hospitals seek to further their physicians' professional advancement by building a staff of physicians who can learn from each other about modern medical techniques and by offering them continuing education to help them keep up-to-date. (Lave, 826–27)

105. Hospitals try to influence the patients' choice of a hospital. Patients occasionally select the hospitals to which they will be admitted, and make their selections on the basis of both price and nonprice considerations. For some hospitalizations, patients are aware of the need for hospitalization a few days, if not longer, in advance of their admission to the hospital. (Lave, 867–68) This is particularly true for "elective surgeries," which can be deferred when necessary or to suit the patient's convenience. (*See, e.g.*, Schramm, 2296; CX 1056B) For these hospitalizations, the patient has some time to make inquiries about the price, quality and convenience of various hospitals. (Lave, 867–68) Friesen's October 1982 strategic plan for AMI's Memorial Hospital of Tampa reported the results of a community survey indicating that 35 percent of those surveyed would ask their physicians to admit them to a specific hospital if they needed hospitalization, and another 54 percent would ask for a specific hospital, but would go to the hospital the physician preferred. (CX 1055F) Some physicians will ask their patients where they wish to be hospitalized. (CX 1030 at 3.8; Anderson, 241–42) When patients ask to be admitted to a particular hospital, their physicians generally will honor those requests if possible. **[42]** (*See, e.g.*, Anderson, 233–34; Boyd, 337, 357–59, 382; Bernhardt, 1238) While some patients may express an interest in the hospital to which they will be admitted, it is the physician who usually determines the hospital to which patients are admitted. (*See* F. 65, 75–77). Dr. Boyd testified that "[t]he decision as to where the patient is admitted is primarily the physician's." (Boyd, 361; *see also* Boyd, 338, 381, 418–19) Dr. Harvey testified that his patients "don't express a preference" for a particular hospital. "Without question I think they rely upon my judgment as to what would be the best place for them to be admitted." (Harvey, 1638) Dr. Schwam testified that pa-

tients "almost never" express a preference for a particular hospital. (Schwam, 578–79)[14] Dr. Bernhardt testified that it is "relatively rare" for his patients to express a preference for a particular hospital and that his patients typically follow his recommendation that they be admitted at Sierra Vista. (Bernhardt, 1237–38)

106. There are some patients who pay part or all of their hospital bills, and so have an incentive to use less-expensive hospitals. First, there are persons who do not have any health insurance. According to a study by the U.S. Department of Health and Human Services, prepared during the early days of the Carter Administration (Schramm, 2288), approximately 12.6 percent of the population has no health insurance coverage at all, and a substantial number of people who have some health insurance coverage do not have enough insurance to cover all of the cost of hospitalization. (Lave, 868–69) Second, people have insurance policies with co-payment and deductible provisions. (Lave, 869) Some policies have co-payment provisions where the policy covers only a certain percentage of the patient's charges, or an allowance towards certain hospital charges. A co-payment provision requiring that the patient pay roughly 20 percent of his hospital expenses is typical for commercial insurance policies. (Derzon, 1986–87, 2013; *see also* F. 96) A co-insurance provision appears in at least one Blue Cross group policy, which is offered to California state employees. (CX 583J–L) Those who lack health insurance coverage and those who have to pay a part of their hospital bills are somewhat **[43]** price-sensitive. (Lave, 869) Studies of the effects of changes in co-payments and deductibles in health insurance policies indicate that when consumers face a 10 percent increase in what they have to pay for medical care in general, and hospital care in particular, their utilization of those services will decrease by 2 percent. In other words, the price elasticity of demand for those services is -0.2. (Lave, 863) This estimate was corroborated by the Health Insurance Study, an experiment sponsored by the Federal Government and conducted by the RAND Corporation, to determine how consumers' usage of health care services is affected by the price they have to pay for it. (Lave, 863–64, 915–16; RX 5752A–G) The decreased usage of services is attributable to both shorter hospital stays and decisions to forego hospitalization altogether. (Lave, 865) In recent years, the percentage of the population that must pay all or part of their hospital bills has been increasing due to: 1) unemployment associated with the current recession, which deprives those who lose their jobs of health insurance (Lave, 846–47); and 2) a trend toward increased deductibles and co-

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[14] Testimony by Drs. Schwam and Harvey should be viewed in light of the fact that there is only one hospital in the South County, where Dr. Schwam practices, and there is only one hospital—French—in the San Luis Obispo area where Dr. Harvey, a cardiologist, can send patients for cardiac cathetherization and cardiac surgery. (Harvey, 1634)

payments in health insurance policies. (Lave, 847; *see also* CX 728A–Z49)

107. Those who pay for all or part of their care may be aware of the relative charge levels of different hospitals. First, hospitals develop reputations for their general level of charges, as former patients talk about their hospital stays. If a hospital has charges patients believe to be excessive, that fact affects the hospital's reputation. (Lave, 848; Carlson, 1360–62; Friedmann, 1580–82) Second, hospitals' general levels of charges are sometimes reported in the press. For example, a newspaper in Salinas, California reported data obtained from the California Health Facilities Commission, including comparative hospital charges. (CX 338B) Mr. Kenneth Friedmann, former controller of French Hospital, testified that the local newspaper would periodically report on the more "visible" charges of the local hospitals, such as room rates and emergency room and operating room charges. (Freidmann, 1582) Room rates, which on average account for about 45 percent of total hospital charges, are particularly "visible." (Derzon, 2100–01; Guy, 635; Lave, 862)

108. Nonprice considerations also affect which hospitals patients prefer. Patients care about the quality of care provided by a hospital, including such things as responsiveness of nurses, quality of the food, and waiting time for various tests. (Lave, 829) Hospitals also seek to make patients comfortable, by providing such things as carpeted floors, color televisions, private rooms and private baths. (CX 1030 at 3.16; CX 1060I) [44]

109. The percentage of the population that is price-sensitive to some degree is large enough to encourage some price competition between hospitals. As Dr. Lave testified:

> They [consumers who are price-sensitive as to hospital services] represent an appreciable proportion of the potential patients for any hospital. And I think that it would be very difficult in this time of excess beds for any hospital to decide that it was going to simply pay no attention to that group.
>
> And so hospitals, I think, have that group precisely in mind when they are trying to worry about setting prices.

(Lave, 869)

110. Hospitals sometimes set low prices on some of their services as part of a deliberate competitive strategy to attract patients. (*See* Lave, 852) The Lewin Report discusses "conscious price competition" between the two hospitals in "Lee County," as evidenced by the new for-profit hospital's policy of holding its room and board charges below those of the established non-profit hospital, and of keeping the differences between the two hospitals' ancillary charges per patient day

unusually low. (CX 1030 at 2.38) The Lewin Report also discussed the strategy of the for-profit hospital in "Cherokee" to promote usage of its new emergency room:

> Magnolia's administrator, replied in the local newspaper, [to charges that Magnolia 'flouted' certificate-of-need regulations in opening its new emergency room], 'We are opening the emergency department at the request of the community and we are moving toward being a full service hospital. Our rates will compare favorably with Houghton Hospital.' Magnolia's pricing strategy and the controversy raised by the local officials which advertised the unit's opening resulted in a quick growth in visit volume.

(CX 1030 at 3.18)

111. Hospitals also recognize that charging high rates can result in loss of business to competitors. Friesen discussed this subject in the strategic plans it prepared for AMI's Community Hospital of Santa Cruz, in Santa Cruz, California, and **[45]** AMI's Circle City Hospital, in Corona, California. In the Santa Cruz situation, Friesen noted that AMI's hospital lost money on room and board, and earned subnormal profits on ancillary services. (CX 1054N) Friesen attributed AMI's inability to set rates sufficient to cover its costs and achieve its profit objectives to "the two hospitals competitive situation in Santa Cruz which does not permit Community [Hospital of Santa Cruz] to adjust rates as easily as other region hospitals." (CX 1054N) In the Circle City strategic plan, Friesen examined the rates of Circle City in comparison to those of other local hospitals (CX 1059D) and other AMI Western Region hospitals. (CX 1059H) One conclusion Friesen drew from that data is that "Circle City is approaching the 'rate ceiling' at which its growth in market share could be impeded by overly aggressive rate increases." (CX 1059H) This reduced growth in AMI's market share would occur because some patients would use competing hospitals if Circle City went over the "rate ceiling." (Loftin, 2525) In AMI's response to comments on its application for a certificate-of-need to build a new hospital in Yuma, Arizona, AMI argued that:

> [A] review of YRMC's [Yuma Regional Medical Center] rate increases indicates that YRMC has difficulty in managing hospital cost without a second hospital in Yuma. Perhaps, a second hospital in Yuma will make YRMC more conscious of the need to contain hospital costs.

(CX 1051M) In addition, the administrator of Sierra Vista felt that a hospital with a reputation for exorbitant prices might well lose patients. (Carlson, 1360–63) Hospital administrators are aware of the visible rates of their competitors. (Steacy, 149–50; Loftin, 1495–96)

112. Hospitals also compete to appeal to potential patients' nonprice preferences. The most important way of doing this is to provide high quality services. (Lave, 829) The Lewin Report notes that the

competing hospitals in the case studies sought to attract patients by opening new services and offering attractive patient rooms, among other things. (CX 1030 at 1.16, 1.20–1.21, 2.16–2.17, 2.47, 3.16–3.17) Friesen suggested that AMI's Brookwood Medical Center convert semi-private rooms into private suites to attract patients. (CX 1060I–J) Hospitals also use public relations efforts, such as advertising, allowing community groups to hold meetings in hospitals facilities, and holding "health fairs" to influence patients' preferences among hospitals. (Lave, 829–30; CX 1030 at 1.16, 1.20, 2.19, 2.24; CX 1054U; F. 157) **[46]**

113. Health maintenance organizations ("HMOs"), self-insured businesses, and "preferred provider plans" act as "group purchasers" of hospital services for their subscribers and employees. They bargain with hospitals to secure hospital services at the lowest cost. (Lave, 833) HMOs receive a fixed fee from subscribers in return for providing their health care. Since hospital care is probably the largest single component of the expenditures of an HMO (Lave, 833), HMOs that do not have their own hospitals have an incentive to negotiate with hospitals for hospital care at the lowest cost; to not only save them money, but also to help them compete against other HMOs. (Lave, 833, 850) They also are interested in making sure that their subscribers receive only the hospital care they require. (Lave, 834) HMOs that do own their own hospitals also contract for hospital services to a limited extent. (*See* Guy, 679)

114. Beginning in about 1978 or 1979, there has been a rapid growth of HMOs in California, particularly HMOs other than the dominant Kaiser and Ross-Loos HMOs. (Guy 639, 641) The approximate percentages of the California population enrolled in HMOs increased from 15% in 1975 to 22% in 1982. (Guy, 641–42) About 7 percent of the total California population is enrolled in HMO's other than Kaiser. (Guy, 679–80) These HMOs have begun to negotiate with hospitals for preferred rates. (Guy, 639) The result was that, not only were Kaiser and Ross-Loos getting discounts, but also by about 1978, discounting to attract the business of other HMOs started to occur. (Guy, 642) At least three AMI hospitals in California engaged in such discounting for the business of HMOs. The "Health Net" HMO received discounts of between 10 and 15 percent of charges from those three hospitals, and another HMO received a discount ranging from 26 to 28 percent (depending upon volume of HMO patient days) from one of the hospitals. (CX 393; CX 414B–D, E–G, H–J) Friesen's strategic plan for AMI's El Cajon (California) Valley Hospital recommended that the hospital seek the business of HMOs that do not have their own hospitals. (CX 1057B)

115. Some large businesses "self-insure" for employee health bene-

fits by paying their employees' health care expenses themselves. (Lave, 833) Such self-insured businesses purchase hospital services for their employees, much like HMOs that do not own hospitals. (Lave, 833) Another type of "group purchaser" of hospital services is the "preferred provider plan." There is no generally accepted definition of the term (Derzon, 2155), but one common characteristic is that preferred provider plans limit the choice of hospitals and other health care providers to be used by their subscribers, and in particular limit the subscribers to lower-priced hospitals. **[47]** (Schramm, 2360) There are preferred provider plans in California. (Derzon, 2154; Schramm, 2360, 2421),

116. In the last three or four years, self-insured businesses have received discounts from hospital rates for their employees' care in California. (Guy, 639) This trend began in Southern California, but eventually encompassed virtually the entire state. (Guy, 643–44) Friesen's strategic plan for AMI's Palm Beach Gardens (Florida) Community Hospital noted that Pratt and Whitney, a large area employer that is self-insured for health benefits (CX 1058B), and that aggressively seeks to control the cost of health benefits (CX 1058B–D), was asking its employees' physicians not to admit them to the hospital (CX 1058B), in part because Pratt and Whitney's medical director believed the hospital's rates were excessive. (CX 1058C). Friesen recommended that the hospital seek to repair its relationship with Pratt and Whitney, and, upon the company's request, consider giving it a discount in return for a higher volume of patients. (CX 1058D) Another Friesen study suggested that AMI's El Cajon (California) Valley Hospital pursue a strategy of developing similar relationships with local employers. (CX 1057B) The Lewin Report noted in one of its case studies that the two hospitals studied competed for a county contract to care for indigent patients. (CX 1030 at 2.20–2.21)

117. In 1982, the California Legislature enacted three bills permitting the Medi-Cal program to contract for inpatient hospital services. (CX 589A, I–J; CX 590A, J–M, R–W, Z20–Z21; CX 599U–X, Z6–Z13, Z43; Guy, 619, 622, 685) The Medi-Cal program has obtained from the U.S. Department of Health and Human Services waivers of certain federal statutes so that the Medi-Cal program may begin contracting for inpatient hospital services with selected hospitals. (CX 593; CX 592D–Z18; Guy, 630–32; 42 U.S.C.A. 1396n(b) (West Supp. 1982)) Such contracting has already begun. (Guy, 655; Derzon, 2023) The objective of Medi-Cal contracting is to stimulate competition among hospitals for Medi-Cal patients, which did not exist before. (Guy, 632–33; *see* F. 122)

118. At the federal level, in 1979, the idea of "competitive solutions" to the growth of the Medicare and Medicaid budgets was discussed

among government policymakers; such solutions involved major structural change of hospital financing mechanisms, among other things, to promote competition in the hospital industry. (Schramm, 2318–20) This activity at the federal level grew out of efforts by Prof. Alain Enthoven and others beginning in the mid–1970's. (Lave, 907) "Competitive solutions" were also presented to, and considered [48] by, the California Legislature around 1978 when the Legislature considered enacting bills providing for state regulation of hospital rates. In 1982, when the legislation authorizing Medi-Cal contracting was enacted, California had severe financial problems in balancing its budget. (Guy, 614) The legislation was enacted on an emergency basis, requiring a two-thirds vote of the legislature. (Guy, 615; CX 559J; CX 590Z21; CX 599Z43) Contracting for Medi-Cal inpatient hospital services with selected hospitals is anticipated to save the state government more than $200 million per year. (Guy, 664)

119. The responsibility for implementing Medi-Cal contracting until June 30, 1983 is vested in a special hospital negotiator (currently Mr. William Guy), appointed by the Governor of California and operating out of the Governor's office. (Guy, 609; CX 590R–S; CX 592P) Under Medi-Cal contracting, the special hospital negotiator negotiates contracts with hospitals to provide inpatient hospital services to Medi-Cal patients. (CX 590R–S) On July 1, 1983, the California Medical Assistance Commission will assume responsibility for Medi-Cal contracting; the special hospital negotiator will become the executive director of that Commission. (Guy, 621; CX 589I–J; CX 590S; CX 592I) The transfer of authority will not significantly affect how Medi-Cal contracting is conducted. (Guy, 663)

120. The special hospital negotiator may select the hospitals with which he will contract through competitive bidding, negotiations, or other methods of procurement. (CX 590A; CX 592L) The selection process for contracting in a Health Facilities Planning Area (HFPA) where there are no existing Medi-Cal contracts begins when the negotiator contacts the hospitals in the HFPA to determine which hospitals would be interested in negotiating contracts. (Guy, 647–48; CX 592L) After a series of discussions with interested hospitals, the negotiator will decide which of those hospitals will receive contracts. (Guy, 650) Once the negotiator has contracted for at least 100 percent of the bed capacity required for Medi-Cal patients in an area, the negotiator can "close" the area, and notify noncontracting hospitals that they are no longer eligible to serve Medi-Cal beneficiaries. (Guy, 650–51; CX 592K–L) Such noncontracting hospitals may be paid for inpatient services rendered to Medi-Cal patients only: 1) in case of an emergency; 2) when a patient whose home is an excessive distance (defined as 30 minutes' travel time, or normal community travel time,

whichever is greater) from a contracting hospital chooses to go to a noncontracting hospital closer to home; or 3) when other minor exceptions to contracting requirements apply. (Guy, 653-54; CX 592I-K) [49]

121. The cost to the state of the services to be provided under a contract will be "a strong driving force in the equation." (Guy, 632) The negotiator will prefer contracts with "per diem" rates (a fixed amount per Medi-Cal inpatient day), but alternative methods of payment will be considered. (Guy, 625-26) The negotiator, Mr. Guy, also will prefer a contract of perpetual length with a 120-day cancellation clause. (Guy, 649) The negotiator will consider the financial ability of hospitals under consideration to carry out their contracts (Guy, 660), and whether the rates offered by the hospital include or exclude payment for hospital-based physicians. (Guy, 649) In addition, the negotiator is required to consider factors such as beneficiary access, and to give special consideration to hospitals that have handled a disproportionate share of Medi-Cal patients in the past. (CX 599Z7; Guy, 686) The state will prefer that a contract cover all services Medi-Cal patients might need, which means that a contracting hospital either must provide all services itself or arrange for other hospitals to provide services it does not provide. (Guy, 662) As a result, hospitals will be negotiating with other hospitals on prices of hospital services. (Guy, 662)

122. The success of Medi-Cal contracting in achieving cost savings for the state of California depends in large part on competition among hospitals for Medi-Cal contracts. As Mr. Guy stated: "[c]ompetition is what we need within the negotiating environment to drive the most cost-effective rate for the state." (Guy, 666) The possibility that a hospital can gain or lose patients, depending on whether or not it receives a Medi-Cal contract, gives the state "leverage" in negotiations:

> It is the basic desire for the patient flow that creates the strongest issue in negotiation. Are you prepared to give up patients? Are you prepared to keep the same number of patients or would you like additional patients? Obviously a hospital with a low occupancy would usually prefer additional patients. And, as a result, automatically creates a leverage in negotiation.

(Guy, 660) Conversely, lack of competition limits the state's options. Mr. Guy testified that the state might be able to work out "capitation" arrangements with some "sole providers," in "very rural areas," whereby the hospital becomes responsible for providing hospital care to the Medi-Cal population in its area, and the state pays a fixed amount per person covered. (Guy, 626-27) In other areas, however, the "lack of [a] competitive [50] environment" would lead the state to "walk away from" those areas. (Guy, 629) In those areas, the existing cost-based Medi-Cal reimbursement system would continue to apply. (Guy, 629; CX 592K, Z5–Z18; CX 593)

123. The legislation authorizing Medi-Cal contracting for inpatient hospital services also permits Blue Cross and commercial insurance companies to contract with selected hospitals for hospital services for their subscribers. (Guy, 668–69; CX 589F–H; CX 599–O–S) This legislation removes a requirement in prior law that prevented insurers from restricting the freedom of their subscribers to choose hospitals. (Guy, 669–70) Blue Cross of California has announced a preferred provider plan, effective January 1, 1983, which will involve negotiations on a price basis with individual hospitals. (Schramm, 2421) Increasingly, third-party payors, particularly preferred provider plans, are attempting to require their insureds to use lower-priced hospitals. (Schramm, 2360) The economic pressures that led California's insurance companies to support the legislation permitting them to negotiate prices with hospitals may lead them to take advantage of that option. (Guy, 672) As described by Mr. Guy:

> The heavy development in California of the HMOs have [sic] eroded a fair amount of the marketplace of the insurance industry in California. Coupled with the heavy movement toward self-insurance where the employer could negotiate rates with hospitals, . . . did not escape the intention [sic] of the insurance industry. . . . They needed a product to offer in that marketplace that was something between the HMO and the 'purer fee for service.' They realized that they were being blocked off from that development because of the law. You added to the fact that the state was getting ready to launch into a negotiated competitive base for Medi-Cal, and the insurance industry acted quite naturally when they said, me, too. . . .

(Guy, 671)

124. In order to expand capacity, add new services, or make major equipment purchases, hospitals must obtain "certificates-of-need" from local planning authorities. (Lave, 830–31; *see* F. 84) Since the planning authorities may limit the number of certificates-of-need to be awarded for any particular program or for expansions of bed capacity, hospitals compete with each other to identify the kinds of facilities and services their **[51]** communities need, and to apply for and obtain certificates-of-need to build and operate those facilities and services. (Lave, 830–32) In its strategic plan for AMI's Community Hospital of Santa Cruz, Friesen urged AMI to oppose the application of Dominican Hospital, Community's sole competitor (CX 1054P), for a certificate-of-need for additional beds. (CX 1054B) Friesen warned that "[i]t is necessary to show that [AMI is] directly addressing community needs, not simply objecting to Dominican's analysis," and

suggested that AMI might do so by offering new or expanded services. (CX 1054B)

125. Competition between hospitals reduces and limits the amount hospitals can charge. (F. 111) Mr. Victor Kolodziej, AMI Vice President and Financial Director for AMI's Pacific Southwest Region (CX 1072G–H), argued that this would occur in Yuma, Arizona if AMI were permitted to build a new hospital there to compete with the established hospital:

> What we are talking about is a deescalation in the build up of rates in the future; that what should happen within the competitive mold is that rates will not increase as they have in the past. It's not the reduction of rates themselves; it's a deescalation in the inflation of rates.
>
> They will not cut rates. We would not cut rates, but rates would not increase as rapidly in the future.

Competition also affords "group purchasers" of hospital services opportunities to bargain with hospitals to further lower charges. For example, Mr. Guy, California's Medi-Cal negotiator, recognized that the state's bargaining position in negotiating contracts for Medi-Cal inpatient hospital services, and therefore the opportunities to reduce the amount the state would have to pay for those services, depends upon competition for those contracts. (F. 122)

126. A related benefit of price competition is that it provides an additional incentive for hospitals to operate efficiently so that they can operate profitably while charging competitive rates. (Lave, 849; *see also* Lave, 902) Mr. Ronald Porter, Group Vice President of AMI and Regional Director for AMI's Pacific Southwest Region (CX 1072H), emphasized this benefit in arguing to a panel of the Western Arizona Health Systems Agency that AMI should be permitted to build a new hospital in Yuma, Arizona:

> We believe that if efficiency is introduced into the marketplace, into our facility, it will allow **[52]** us the opportunity to have rates which are lower or at the top end to be that of Yuma Regional Medical Center and that we believe that competition in this case will force both facilities to be very mindful. I think it will force both facilities to become efficient.

(CX 1072V)

127. Competition between hospitals forces hospitals to anticipate, and respond to, the needs and desires of patients, physicians, and their communities. Physicians have some leverage over a hospital if they can admit their patients elsewhere should they become dissatisfied with a hospital. Mr. Kenneth Ono, an Operations Assistant with AMI's Pacific Southwest Region (CX 1072H), and a former adminis-

trator of a hospital in Hawaii (CX 1072M), described how physicians there felt about this aspect of competition:

> [T]here were two hospitals there, and one of the comments physicians used to make was, "Oh, it's really a hassle going back and forth" . . . . [O]n the other hand they said, "We like it when there's competition," because . . . they can indicate to the administrator about the progressive new things that are being done in one hospital and why can't they be done in another. . . .

(CX 1072M) The Lewin Report also noted that physicians in the communities studied benefited from the opening of a second hospital in each of those communities because that increased their leverage vis-a-vis the hospitals. (CX 1030 at 1.30, 3.14) Competition also gives hospitals an incentive to identify community needs early, and to promptly apply for certificates-of-need for services to respond to those needs. (Lave, 832) Competition benefits patients by keeping hospitals and their employees "on their toes." (Lave, 835; CX 1030 at 1.29–1.30, 2.47, 3.42) The result of keeping hospitals "on their toes" was summarized by Dr. Lave:

> I think that the primary effect of non-price competition is to keep institutions on their toes, to keep them from becoming ossified in what it is that they are doing; to try and look for new opportunities, and to try and take a look for new ways of serving physicians and patients; to keep them from simply sitting back and responding when physicians or people in the community say that they need something but instead to aggressively go **[53]** out and try to find out what the market looks like, what people will want. That is very good for the whole community.

(Lave, 835) A doctor supporting AMI's proposal to build a new hospital in Yuma, Arizona, described the effect of this kind of competition on the quality of hospital care:

> I believe that Yuma Regional Medical Center is a good community hospital. In the past four years there have been significant improvements. Nevertheless, it is my belief that these improvements would have occurred sooner had there been competition in the area. Of more importance, as medicine changes, so must the entire medical community and I believe that competition will clearly help to keep both hospitals closer to the forefront of medicine.

(CX 1050X)

128. Another benefit of competition is that there is a wider range of choices available to patients. For example, competition has stimulated the trend toward innovative obstetrical services and policies—including things which some parents desire, even if they are not necessarily associated with high-quality medical care. (Lave, 836–37) The Lewin Report observed that consumers in the communities studied generally appreciated the expanded choices available to them

because of competition. (CX 1030 at 1.29–1.30, 3.42) It also noted that the poor in those communities benefited from the increased availability of services brought by competition. (CX 1030 at 1.30) Competition also forces hospitals to develop expertise in their areas of "comparative advantage." Competition encourages hospitals to develop particular areas of expertise where they have a "special role in the community." (Lave, 838–39) The strategy of "Selective Centers of Excellence" adopted for AMI's Brookwood Medical Center (CX 1060I–L), and discussed above (F. 101), is an example of a hospital pursuing its "comparative advantage." Finally, competition for certificates-of-need for new facilities and services presents health planning authorities with the opportunity to solicit competing applications, so that they may have more options as to where a new facility or service ought to be located. (Lave, 832)

129. Competition among hospitals produces substantial benefits to patients and their physicians, and improves the quality of hospital care. Dr. Lave, complaint counsel's expert **[54]** witness, presented the following overview of the benefits and costs of nonprice competition:

> There are always adverse effects of competition. When anybody looks at it, when a Soviet planner looks at competition, he sees excessive capacity being built in one place, some other capacity sitting idle in another place, he sees luxury here that need not be present and so on.
>
> There is always something in competition that gets people who don't understand it irritated because it always looks as if this could be done more efficiently if we had somebody in charge who could give the orders. The fact is that over time these relatively minor excesses that come about because of competition are disciplined by the marketplace and help to keep the competitors on their toes and to lead to a greater efficiency.
>
> So that this is just as true with respect to hospitals as it is with other areas of the economy. I think that on balance this kind of nonprice competition is extremely productive both in terms of the quality of patient care that one would see as defined by health professionals and the quality of patient care as patients would view it, which is probably just as important as the quality of care as defined by health professionals.

(Lave, 839–40) The benefits of nonprice competition are reinforced by the fact that the certificate-of-need process imposes at least some control on competition for new equipment and facilities, which might otherwise become "somewhat destructive," and by the regulatory safeguards preventing quality of care from falling below a fairly high minimum level. (Lave, 825, 843; *see* RPF 7.14–7.16) AMI Group Vice President Ronald Porter, arguing before a panel of the Western Arizona Health Systems Agency, in support of AMI's application for approval of a new hospital in Yuma, Arizona, expressed succinct evaluation of the benefits of competition: "Competition is good. Competition is healthy for the Yuma community." (CX 1072T) Finally, the Lewin Report summarizes how consumers in the communities it studied felt about the competition resulting from the entry of a new hospital:

> Each reader will make his own decision as to whether benefits [of hospital competition in the cases studied] to this point have outweighed the [55] costs. Consumers to date feel they have, which is the market test.

(CX 1030 at 1.32)

J. *Hospital Competition in San Luis Obispo County*

130. Prior to AMI's acquisition of French, San Luis Obispo County presented a situation in which many of the types of competition previously described could and did flourish. The county was well-supplied with physicians (*see* RX 5435Z16), and since all the hospitals had open privileges, these doctors could practice at any one of the five hospitals in the county. (Anderson, 224; *see* Boyd, 327) In addition, there was substantial excess capacity throughout the period preceding the acquisition. In 1978, for example, the average occupancy rate for all five hospitals in the county was only 54.2 percent. (RX 5835) Furthermore, the hospitals had particular strengths and weaknesses, so patients and physicians were presented with a number of choices among the hospitals. (F. 131–133)

131. The city of San Luis Obispo was the hub of health care services in the county. (CX 255H) It contained the largest hospitals in the county, Sierra Vista with 172 acute care beds, and French with 138 acute care beds. (CX 736B) Both hospitals offered a wide range of services. Sierra Vista, which was considered one of AMI's finest hospitals (CX 307), had an active emergency room and offered CAT scanning, nuclear medicine and ultrasound. (CX 283J–L) French also offered a number of specialized services, including CAT scanning, cardiac catheterization, and pediatrics. (CX 271B, D;; Boyd, 375–76) In addition, it was recognized for the quality of its nursing staff and the quality of food served to patients. (Loftin, 1480–81; Anderson, 223)

132. SLO General, also in the city of San Luis Obispo (CX 736B), was heavily subsidized by the county (CX 41C; *see* Bernhardt, 1304), was the choice of people without health insurance and those who relied on the county to pay for their health care. (Boyd, 359; Schwam, 576–77) SLO General was not as modern as French and Sierra Vista and was considered by many doctors as inferior to French and Sierra Vista. (F. 135) SLO General is the hospital of choice for obstetrics; it was the first hospital to offer facilities for natural childbirth. (RX 5436Z28)

Periodically, there had been discussions concerning closing SLO General. (CX 41C; Bernhardt, 1260)

133. There were also two hospitals outside the city of San Luis Obispo. Twin Cities was the only hospital in the North County, from where it drew almost all of its patients. (F. 55) **[56]** Twin Cities did not offer as many services as French or Sierra Vista. For example, it did not have a separate pediatric department, and had no cardiac catheterization or CAT scanning capability. (*See* CX 288J) In addition, it had only 84 beds, fewer than either French or Sierra Vista. (CX 736B) Arroyo Grande is the only hospital in the South County. It had only 79 beds. (CX 736B) It had neither a CAT scanner nor an obstetrics department. (CX 266B; CX 268I) In addition, it was not as well-equipped as the hospitals in the city of San Luis Obispo. (Schwam, 585)

134. Prior to AMI's acquisition, competition between the hospitals in the county took place primarily between French and Sierra Vista. First, the hospitals competed to attract doctors to admit to their facility. (Anderson, 232) Dr. Boyd testified:

> Q. When you choose to admit a patient to one hospital, obviously to the exclusion of others, how does your choice affect that hospital to which the patients is admitted?
>
> A. Of course, it affects their cash flow very directly. The decision as to where the patient is admitted is primarily the physician's and so the hospital is very interested in attracting the physicians to admit patients.

(Boyd, 361) Second, there was pressure on each hospital to satisfy the needs of the doctors who were already admitting there, since they could always admit patients to one of the other hospitals. Mr. Anderson, the former administrator at French, explained:

> Obviously I didn't want my patients going to Sierra Vista or any other hospital for that matter. So we did try to create an environment which would encourage [doctors] to continue bringing their patients to French Hospital.

(Anderson, 231) This competition for doctors gave the hospitals an incentive to provide the best health care possible. (Carlson, 1321, 1328)

135. Hospitals compete for physicians by offering them the kind of equipment and services that the physician believes his patients will need. (Lave, 826) Whether a hospital has necessary equipment is a major factor in a doctor's decision where to admit patients. (Boyd, 337; Bernhardt, 1288) Hospitals in San Luis Obispo purchased equipment physicians **[57]** needed in order to ensure that they would continue to use their facilities. For example, Sierra Vista's administrator noted:

> One area of marketing that we have always tried to pursue is that of provision of

> equipment as necessary and as requested by the Medical Staff. One of these items was a duodenoscope and an inflatomatic tourniquet for use in the Emergency Room. These are both a result of direct requests from physicians which we were able to rapidly process.

(CX 453B) At another time, he noted that the hospital's revenue from ancillary services had been increased as a result of "satisfying the requests and requirements of the Medical Staff for equipment and services." (CX 318A; *see also* Carlson, 1321) French also attempted to attract physicians by providing improved services and needed equipment. Such competition had taken place with regard to certain ophthalmalogy equipment. According to one witness:

> The hospital, the partners, tried to improve the services to attract more physicians to admit their patients to French Hospital. I think that the most notable example would be with the ophthalmalogists.
>
> They obtained additional equipment that the ophthalmalogists wanted and, as a result, now most of the ophthalmalogy is being done at French Hospital as opposed to the fact that it used to be done at Sierra Vista Hospital.

(Boyd, 368; *see also* Bernhardt, 1250) SLO Hospital was less successful in attracting doctors to practice there. SLO General was viewed as the primary obstetric facility since it offered "contemporary modalities of practice," including natural childbirth. (RX 5436Z28) It was the hospital of choice for obstetrics. (Boyd, 386, 420) And, at certain periods, the hospital also had certain other facilities, such as a burn unit and a renal dialysis unit, which other hospitals did not have. (Anderson, 267) It was the hospital of choice among physicians whose patients required these services. (Schwam, 576–77) With these exceptions, however, SLO General did not compete significantly for physicians with French and Sierra Vista. Most doctors did not practice at SLO General because it lacked necessary equipment and services or because the equipment it did have was inferior to that available in other hospitals. It was "anachronistic" and its operating rooms were "primitive." (Stahl, 1404) Mr. Anderson testified: [58]

> Most of the physicians did not use San Luis Obispo General on a regular basis because they lacked the facilities that they desired.

(Anderson, 305; *see also* Anderson, 226; Boyd, 338) Dr. Bernhardt also testified that he would try not to use SLO General for certain procedures not usually done there. (Bernhardt, 1238) He noted a number of deficiencies in the equipment available at the hospital. He stated:

> It is very outdated in its equipment. The No. 1 weakness is the x-ray department. It is quite inadequate in what it can do; no scanning equipment or angiograms or things

> of that nature. It has a small and in-constantly [*sic*] used intensive care unit which isn't too hot, basically. . . . You don't feel like they are up to the speed in terms of what is going on.

(Bernhardt, 1243) The John James Report came to a similar conclusion about SLO General. (RX 5022Z43) Dr. Boyd noted:

> Mr. James is referring to the fact that the equipment at General Hospital was not up to the standards of the other hospital and the staff, medical staff, had expressed to him that that is why they weren't taking patients there.

(Boyd, 395)

136. Although few doctors from outside the city of San Luis Obispo regularly used the hospitals there, the possibility that these doctors might admit some patients there imposed some competitive pressure on hospitals in the outlying areas. The existence of French as an independent hospital provided a way of bringing pressure to bear on the Arroyo Grande administration when new equipment was needed. Dr. Schwam testified:

> [M]odernizing Arroyo Grande Hospital and stimulating administration to get what we thought was adequate equipment has always been a problem. . . .
>
> * * * * * * *
>
> So the medical staff had a certain amount of leverage in a sense because we could always point [**59**] to French Hospital in terms of equipment that we felt that we needed and that we were not getting. Some members of the medical staff even stated that they would take their patients to French Hospital if certain basic equipment was not forthcoming.

(Schwam, 585; *see also* Schwam, 593) Dr. Schwam did not generally admit patients to French, but he used that option as a way of "alerting administration that we wanted progressive changes." (Schwam, 585–86) AMI recognized this competitive pressure. In a report prepared by the staff of AMI Vice President Norman Loftin (Loftin, 1492) concerning Arroyo Grande, it was noted that "among the physicians in the community, French is used over Sierra Vista, another American Medical International Hospital, because of the philosophy that subtly suggests to the corporation that it invest in the same quality and level of care in both Arroyo Grande and Sierra Vista." (CX 197G; *see also* CX 197N)

137. Competition for doctors, especially between French and Sierra Vista, resulted in the hospitals' purchasing needed equipment and improving the quality of services. For example, competition for doctors through the provision of equipment had a major impact on how the present French Hospital was equipped when it was built. The equipment in the original French hospital was described as "very

poor" (Boyd, 354), and the hospital generally was considered by doctors to be the worst of the three hospitals in the city. (Boyd, 351) The equipment at Sierra Vista, on the other hand, was described as "superior." (Boyd, 352) When the new French Hospital was built in 1972, the administration "tried to furnish the necessary instruments and the equipment that would encourage physicians to use French Hospital." (Anderson, 232) For example, special equipment for neuro-surgery was provided so that a neurosurgeon in the city would use French for his surgery. (Anderson, 233)

138. Prior to 1970, Dr. Boyd and Dr. Cletsoway, two urologists, admitted their patients to Sierra Vista. (Boyd, 340) Dr. Boyd had been Chief of Staff at Sierra Vista and later held the same position at French and SLO General. (Boyd, 342) When the new French Hospital was being built, Dr. French asked Dr. Boyd and Dr. Cletsoway what urology equipment the hospital should be equipped with, and their suggestions were incorporated into the facility. (Boyd, 340–51) As a result of this new equipment, Dr. Boyd and Dr. Cletsoway began admitting more patients to the new French Hospital. (*Id.; see also* Anderson, 233) When Dr. Boyd and Dr. Cletsoway switched patients to French, this reduced the revenue which Sierra Vista received. In order to recapture this business, the hospital bought new equipment. Dr. Boyd testified: **[60]**

> Sierra Vista Hospital decided to upgrade their equipment in order to move us back, and they acquired some new equipment but it wasn't as good equipment as French had.
>
> So we told them we wouldn't come back until they had as good equipment as French. It think it took about two weeks and they had the other equipment, so that they had exactly the same equipment as French had.

(Boyd, 356)

Subsequently, the third hospital in the city, SLO General, also purchased the new equipment in order to attract Dr. Boyd. (Boyd, 356) However, it took approximately a year-and-a-half for it to get the equipment, during which time Dr. Boyd did not use the hospital for urological surgery. (*Id.*) Thus, as a result of the competition for Dr. Boyd's patients, the urology equipment was substantially upgraded at all the hospitals in the city.

139. Dr. Harvey noted another instance in which the competition between the hospitals resulted in equipment being upgraded. When Dr. Harvey arrived in San Luis Obispo, both French and Sierra Vista owned primitive forms of an important diagnostic tool used in cardiology, a Swan-Ganz catheter. (Harvey, 1685) Shortly after his arrival, French upgraded its equipment at Dr. Harvey's request. Within weeks Sierra Vista and SLO General also purchased those items,

again, at Dr. Harvey's urging. (Harvey, 1685–86) Dr. Harvey noted it was important for him as a cardiologist to have this relatively inexpensive piece of equipment. (Harvey, 1685)

140. The quality of nursing was one area in which the hospitals competed. French Hospital was distinguished by the quality of its nursing and the level of its staffing. Although the original French Hospital was a poor facility overall, the nursing care was "remarkably good . . . it was almost like being taken care of by mother at home." (Boyd, 349) The nursing care at the present French was also excellent. French was also the first hospital to offer "total patient care," a nursing method which utilized more registered nurses and fewer nurses' aides. (Collins, 1433) French's higher nurse-patient ratio gave it a competitive advantage over other hospitals in town. (Anderson, 221) An AMI official acknowledged that one of French's strengths prior to the acquisition was its excellent nursing care. (Loftin, 1481) The nursing care at Sierra Vista was **[61]** described as inferior to French, at least partly due to the fact that Sierra Vista suffered from nursing shortages. (Boyd, 378; Bernhardt, 1256) An internal AMI memorandum in April 1978 described the "chronic nursing problems" identified by the new Director of Nursing. These problems were:

> [P]rimarily, an inadequate number of proficiently trained nurses to cope with a high census, patients being refused entry to ICU/CCU due to inappropriate or unsafe (State Criteria) staffing levels, nurses reportedly worked harder for salaries earned, concern for the performance of nursing school graduates. . . .

(CX 308B) Nursing at SLO General was considered to be quite good. (Bernhardt, 1242) However, the relatively low utilization rate affected the staff's capability to deal with problems that might arise, and this affected the extent to which doctors used the hospital. (Bernhardt, 1297)

141. These differences in the quality of nursing care affected doctors' decisions where to admit patients. Nurses in the intensive care units of SLO General were less experienced with certain problems than nurses at the other hospitals. (Bernhardt, 1297–98) As a result, doctors were less likely to admit certain patients to that hospital. (*Id.*) Another doctor stated that he used French because the equipment was superior and because "the patients got excellent nursing care in addition to that. So I though one of my patients could receive excellent care." (Boyd, 361; *see also* Boyd, 338) Competitive pressure was one reason that French continued to keep nursing levels high, despite pressure to cut them considerably. In 1978, two studies were done at French which recommended reducing the level of nursing. (*See* Collins, 1440–41) Although staffing levels were reduced somewhat, they

were never reduced to a level as low as that recommended by these two groups. (Collins, 1441) The decision to leave the nursing levels high resulted, at least in part, from the owners' fear that reducing staffing levels would cause certain doctors to go elsewhere. For example, one recommendation was to reduce staffing in the operating room; however, such a reduction would have meant staffing only two operating rooms, instead of four. (Boyd, 373) Had such a reduction been made, some surgeons would have scheduled operations at other hospitals. (Boyd, 374)

142. French also competed for physicians through its pediatric department. It was considered "outstanding" and "the best pediatric department in town." (Boyd, 376) Therefore, most of the pediatricians in town used the service at French. (*Id.*) In **[62]** addition, French competed by virtue of its CAT Scanner which was superior to the one at Sierra Vista. (Boyd, 355)

143. Hospitals compete for physicians by providing a qualified medical staff with which their doctors can associate. (Lave, 826–27) Doctors want to be associated with a first-rate hospital. (Carlson, 1323) This ensures that patients will receive proper care and gives doctors the opportunity to learn new techniques. (Lave, 826–27) French worked hard to attract quality physicians to practice there. During the period that the physicians owned French, they brought a number of new specialists into the French Clinic. In bringing in these physicians, the French Clinic doctors were interested "in the expertise they would bring to our role as being as complete as possible in the practice of medicine." (Harvey, 1697) When French was purchased from Dr. French, offers were made to physicians from outside the French Clinic group. (Bernhardt, 1247) In early 1978, three physicians accepted limited partnerships in the facility. (Boyd, 365–66; Anderson, 224) In October, 1978, offers were made to eight other physicians, two of whom accepted. (CX 732; Boyd, 365–66; Anderson, 225–26; Friedmann, 1587)

144. The loss of physicians to French concerned Mr. Carlson, the administrator of Sierra Vista. After the first offering of French partnership shares in 1978, Mr. Carlson reported to Mr. Loftin that "[a]n unknown factor in physician utilization of the hospital is the increasing number of physicians who have been invited to buy into French Hospital." (CX 317B) By October 1978, when the second offering was made, Mr. Carlson was even more concerned. He wrote that:

> Because of doctor ownership, past increases in the number of physicians and possible future additions to the Clinic makes that hospital an increasingly formidable competitor for the limited number of patients in the area.

(CX 318B)

145. Hospital competition for doctors had several beneficial effects. First, supplying doctors with equipment which they needed resulted in all three hospitals purchasing up-to-date and necessary equipment. (F. 135–139) In other cases, it caused the hospitals to establish a "comparative advantage," such as French's nursing staff and its pediatric department. (F. 140–142) Secondly, competition for doctors resulted in each hospital having a well-qualified medical staff who took pride in the particular hospital they were associated with and who were **[63]** likely to support the hospital by admitting patients there. This resulted in the quality of care remaining high. Dr. Boyd stated:

> In each of the institutions there was pride and loyalty to the institution. The French physicians on the French medical staff felt . . . a real pride in that hospital and tried to maintain as high a quality as possible.

(Boyd, 367) In addition, the hospitals had an interest in promoting this bond between the doctors and the hospital because it meant that doctors were less likely to switch to another hospital. Dr. Bernhardt noted this fact:

> It is just, I don't know, almost a fellowship thing. If you are at Sierra Vista, that is sort of your home base. It you were from French, that is your home base. It is like switching churches, I guess. It was sort of [an] identity thing.

(Bernhard, 1251)

146. Competition for doctors did not have any serious adverse effects on patients or the quality of care, nor did it result in the purchase of unnecessary equipment, or encourage unnecessary hospital admissions. Some equipment which was purchased was relatively inexpensive and easy to obtain. (Harvey, 1686) French and AMI had procedures whereby they reviewed doctors' requests for equipment in order to ensure that it was necessary, financially feasible, and useful to more than one individual. (Carlson, 1324; Loftin, 1489; Friedmann, 1574–75) Furthermore, such requests were reviewed by committees so that there is "a consensus before we expend significant amounts of money. . . ." (Carlson, 1324) Each hospital balanced its need to keep physicians satisfied with other financial considerations, including the return to the hospital. (*See* Friedmann, 1575) Finally, the health planning laws further inhibit unnecessary expenditures by hospitals since some equipment cannot be purchased without a certificate-of-need, and such certificates will not be granted if unnecessary duplication or low utilization will result. (Lave, 842–43; *see* F. 84–88)

147. It was asserted that doctor ownership of French resulted in a

conflict of interest since the doctor-owners benefited from admissions. (*See* Bernhardt, 1247; RPF 10.41–10.47) There is no reliable evidence that doctor ownership of French resulted in patients being admitted unnecessarily to the hospital. Dr. Harvey testified: **[64]**

> Q. Do you believe that, in fact, partners at French Hospital were admitting patients unnecessarily?
>
> A. I think we had bent over backwards not to, quite frankly.

(Harvey, 1698; *see also* Boyd, 377–385) Dr. Stahl, who as pathologist examined tissue removed during surgery to determine whether or not it was diseased, stated that there has not been any change in the amount of undiseased tissue which he has seen since the hospital was acquired by AMI. (Stahl, 1416) There is also no reliable evidence that doctor ownership resulted in patients being kept in the hospital for an unnecessarily long time. Mr. Mittelstaedt prepared several charts which purported to show that the average length of stay at French had decreased since the doctors sold the hospital. (Mittelstaedt, 1067; RX 5744) This chart failed to account for the fact that a number of physicians retired or took sabbaticals when the hospital was sold and others devoted less time to their practice. (Stahl, 1417–18; Harvey, 1698–1700) In fact, Mr. Mittelstaedt admitted that when one such doctor was excluded from his charts, there was very little change in the length of stay. (Mittelstaedt, 1177–79) The hospital length of stay has been declining in recent years nationwide. (Mittelstaedt, 1179) In addition, there are a number of factors that safeguard patients, including the medical ethic instilled in medical students; the tissue and other staff committees; accreditation review; peer review (Derzon, 1948, 1971; Schramm, 2277); and continuing licensing requirements. (Schramm, 2302–03)

148. Much evidence was received about the existence of "polarization" in the medical community which prevented competition for doctors from taking place. (Carlson, 1238–29; Loftin, 1485–86; Friedmann, 1588) According to this contention, there were two groups of physicians in San Luis Obispo; those associated with French Clinic who admitted exclusively to French, and others who would admit only to Sierra Vista. (*See* Friedmann, 1575–77, 1588; Loftin, 1482) Due to the animosity between the two groups, it was argued that no doctor would switch from one hospital to the other. Apparently the source of this animosity went back to the late 1950's, although according to Mr. Mittelstaedt, "it was not clear that people even remembered why such polarization had existed in the past." (Mittelstaedt, 1031) According to Mr. Friedmann, the polarization supposedly had as its cause the fact that in the 1950's Dr. Edison French bought and closed

down Mountain View Hospital, thereby alienating the physicians who had formerly practiced there. (Friedmann, 1576–77) These physicians subsequently formed Sierra Vista Hospital. (Friedmann, 1577) **[65]**

149. The competitive effect of physician polarization in San Luis Obispo is marginal. First, it is not unusual for doctors to be affiliated with a single hospital. (Derzon, 1981) In most cases, it is easier for a doctor to have all inpatients in a single hospital near his office. (Bernhardt, 1237, 1285–86; *see* Harvey, 1682–83) Secondly, it was not true that each hospital was exclusively supported by a discrete group of doctors. Some of the doctors who supported French did not have an ownership interest in the hospital. (*Compare* CX 56H–K *with* CX 38Z11) According to one of respondents' charts, RX 5740, in fiscal year 1978, only 60 percent of French's admissions came from doctors who were general partners in Central Coast Hospital Company. In fiscal 1979, which ended prior to the acquisition, only 53 percent of French's admissions came from these doctors.[15] RX 5740 refers only to general, not limited, partners. (Mittelstaedt, 1066) However, it seems unlikely that the limited partners made up the remaining admissions since several of them, including Drs. Boyd, Cletsoway, Kettlekamp, McAdams and Tedone tended to admit evenly between French and Sierra Vista. (*See* Boyd, 409; *see also* Boyd, 364–66; Anderson, 224, 226; CX 56J) Other doctors who were members of the French Clinic also used hospitals other than French. "[T]o be honest with you, especially with the hemotologists, oncologists and gastrointerologists [who were part of French Clinic] . . . [they] admitted most of their patients elsewhere." (Harvey, 1697; *see also* Anderson, 248–49) Also, doctors who admitted to Sierra Vista switched to French. A memorandum written shortly before the acquisition was completed notes that "French may have persuaded a couple of doctors to patronize their facility," and then lists the names of five doctors. (CX 56F)

150. Much of the so-called polarization in the community could have resulted from competition which existed among doctors for patients. There was "intense competition" among physicians for patients. (Friedmann, 1586–87) This competition increased the animosity which existed among doctors in the community. For example, Dr. Bernhardt noted: **[66]**

> [T]he [French] Clinic was very expensive. Right after they bought the hospital they brought in new physicians, and some of us felt a little threatened by that. They were bringing in competitors.

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[15] In fiscal year 1978, 2281 of French's 3771 total admissions came from doctors with an equity interest in the hospital; the next year, 2234 of its 4152 admissions were from such doctors. (RX 5740)

(Bernhard, 1246) Competition between doctors was exacerbated by the existence of two clinics in the county, the French Clinic and the San Luis Medical Clinic. (Boyd, 352) Not surprisingly, the San Luis Clinic doctors admitted primarily to Sierra Vista, instead of using the hospital owned by members of the rival French Clinic. (Mittelstaedt, 1032–33) Furthermore, these rivals tended to disparage each other. For example, questions about Dr. Edison French's capabilities were "played up most by those who didn't practice with him." (Bernhardt, 1245) Indeed, the existence of this competition between doctors, which presumably still continues, explains why some residual polarization exists today. (*See* Stahl, 1387)

151. Although it is doctors who admit patients to hospitals, in some few instances patients influence where they will be admitted. This occurred in San Luis Obispo. A number of witnesses noted that patients have an impact on where they are hospitalized. Mr. Anderson explained:

> Patients are people . . . for whatever reason they may have a preference for not going to a hospital or wanting to go into another hospital. They may well express this desire to their attending physician.
>
> I assume everything else being equal, that the physician would honor the patient's request. . . .

(Anderson, 233; *see also* Steacy, 152–53) "Where the patient prefers to go" was the primary consideration of at least one doctor in San Luis Obispo in deciding where to hospitalize patients. (Boyd, 337) Other physicians instructed their receptionists to give patients in need of hospitalization the option of going to either French or Sierra Vista. (Anderson, 242) In those instances when a patient expressed a preference, doctors usually attempted to honor it, if possible. (Bernhardt, 1238; Boyd, 382) Patients had various reasons for preferring particular hospitals. Sometimes a patient would have been in the hospital before, and whether they had had a good or bad experience would influence where they wished to go. (Boyd, 357) Many people preferred to go to French, "since Dr. French had a very loyal following." (Boyd, 359) A small proportion of people preferred to go to SLO General. (Boyd, 357) Usually, it was indigents (Schwam, 577), people responsible for their own **[67]** hospital bills (Boyd, 359), and county employees who liked to go there. (Bernhardt, 1241)

152. Some patients were sensitive to price. The recessionary economy had the effect of reducing admissions to the hospital. (Carlson, 1364–65) Some patients expressed their concern about price, and some asked their doctor where it would cost the least to be hospitalized. Dr. Boyd estimated that in twelve years of practice only about 10 patients

(approximately 1 percent) had requested one hospital over another based on price. He acknowledged, however, that unless a patient expressly mentions price, a doctor cannot tell whether price influenced a patient's choice of a hospital. (Boyd, 408–09, 429–30) One doctor estimated that "at least 20 percent of the patients that I proposed hospitalization to express concern about hospital charges." (Schwam, 579) A substantial number of people who worked in San Luis Obispo County, and their families, were covered by group health benefit plans that have "copayment" provisions requiring them to pay a substantial part of their hospital bills. Brochures for 12 such plans appear in the record. Those plans require covered patients to pay "co-payment" for all or some types of expenses for short-term hospital stays (subject to deductibles, and limitations on co-payments for "catastrophic" expenses) at rates ranging from 10 percent to 30 percent, with a 20 percent rate being typical. (CX 555I–K, O–Q,Z51; CX 557C–D; CX 558D, F; CX 559A,Z16,Z82; CX 561G–H, K, X–Z23; CX 562D, M–Q; CX 563Z13–Z15, Z22, Z216–Z217; CX 583F–G, J–K, N–O, S(a)–T) Those 12 plans cover at least approximately 2750 employees, and their families, in the San Luis Obispo area. (CX 556A; CX 557A; RX 5435Q)

153. Since it is difficult for a patient to determine in advance how much his or her hospital stay will cost (Steacy, 191), patients tend to be aware of only the more general price information or the more visible charges. Two doctors who gave patients a choice of Sierra Vista or French informed patients in advance that "in all likelihood" French would be more expensive. (Anderson, 242) General price information was also disseminated through the newspapers. Periodically, the local newspaper reported on the hospital charges in the community. "That is, they would take and do a little box type affair in the paper with corresponding articles on health care and show the visible, like room rate, the operating room charge, the emergency fee charge, that type of thing." (Friedmann, 1582; *see also* Schwam, 580–81; CX 338B) Since patients are aware of only general price information, it was important for hospitals to maintain their reputation as reasonably-priced hospitals. If a hospital had a reputation for exorbitant **[68]** prices, it might well lose patients. (*See* Carlson, 1360–62; *see also* Friedmann, 1580)

154. The hospitals in San Luis Obispo were careful about their rates in those areas about which patients were likely to be most knowledgeable. Hospital administrators and AMI officials checked room rates both within the county and in other areas. (Loftin, 1495) Mr. Friedmann, who was in charge of pricing at French prior to the acquisition, kept track of room rates at hospitals in the county and throughout the

state. (Friedmann, 1580) Mr. Friedmann suggested that such examinations had a competitive purpose. He testified:

> There is natural tendency to examine these rates in the sense that certainly you don't want to be terribly out of line or competitively out of line in the sense of, if I were overly high, I would know that maybe I have a problem within my facility as to my costs that had to be examined. Plus from a public relations standpoint, you don't want to be the highest priced show possibly in town.

(Friedmann, 1580) Documents show that AMI was concerned with room rates in the county. An Arroyo Grande planning document includes a survey of room rates, but only those in the county. (CX 191H–I) A memorandum analyzing the upcoming French acquisition similarly notes only those rates at hospitals within the county (CX 38N), the same hospitals that are referred to as French's competition. (CX 38M) Another AMI memorandum suggests that there was room for Sierra Vista to adjust its rates, based on a study of room rates at hospitals in the county. (CX 479; *see also* CX 480)

155. Evidence indicates that competition also had an effect on other charges that were likely to be "visible" to consumers, the operating room and the emergency room fees. (*See* Friedmann, 1582) In Spring of 1978, the installation of a new computer allowed French to change from a per-hour operating room charge to a unit pricing system. (Friedmann, 1582, 1625–26) As a result, operating room charges were changed so that the "front-end charge" was reduced but, due to various "weighting factors," the total revenue could be increased. (Friedmann, 1583) This change did, however, result in lower operating room fees for some patients. (Friedmann, 1626) The reduction in the "front-end charge" was "the actual visible fee . . . that would normally be published, for instance in the paper." (Friedmann, 1583) French reduced another visible charge, the emergency room charge. Doctors used the French emergency room on weekends instead of opening up their offices. Usually there was a charge **[69]** for the use of the emergency room, but it was waived when doctors saw patients under these circumstances. Mr. Friedmann stated that the reduction was just for weekends, but it may have been more than that since Dr. Bernhardt stated it applied to "off-hours." (Bernhardt, 1248–49) This change in charges may not have had an effect on doctors' admission patterns, but it did affect patients' choice of doctors. (Friedmann, 1585) The change was "more of a patient-getting technique for the members of the French Medical Clinic than anything else." (*Id.*) Since doctors in the Clinic often admitted to French (Friedmann, 1588; *see* Bernhardt, 1249–50), any increase in patients from such a move would ultimately redound to the hospital's benefit in the form of increased census. There was concern at Sierra Vista about the competitive moves of

French Hospital. In a letter to Mr. Loftin, a local physician who practiced at Sierra Vista noted the changes in fee schedules and stated: "It is . . . becoming apparent that this hospital [French] is attempting to generate competition . . . and thus is become [sic] extremely competitive with Sierra Vista Hospital." (CX 737) The doctor went on to state that AMI should consider changing its emergency room fees "to be competitive. . . ." (*Id.*) Mr. Loftin replied on February 12, 1979, while AMI was considering the acquisition of French (CX 738; *see* CX 38): "We have been aware of the competitive moves of French Hospital and will most certainly work to counteract these." (CX 738)

156. There is evidence that hospitals attempted to offer high quality care so as to satisfy patients. (Lave, 829) The doctors at French "tried to maintain as high a quality as possible." (Boyd, 367) An AMI Quality Assurance report notes that Sierra Vista physicians recognized that they were competing with physicians at other hospitals to provide the best possible care. The report notes:

> Almost without exception the physicians expressed their concern about being in competition with other hospitals in San Luis Obispo area and indicating that they had the wherewithall to do a more effective job in delivering health services than any of the competition.

(CX 307) The hospitals also competed for patients by offering needed services that were not available at other hospitals in the area. In 1975, French Hospital, which was still owned by Dr. French at that time, set up a heart catheterization laboratory. (Harvey, 1648) This lab allowed cardiologists to diagnose heart disease (*Id.*), and meant that patients in need of this service were treated in San Luis Obispo rather than having to go elsewhere. This program was viewed by French as a **[70]** way of competing with Sierra Vista since it was a source of referrals. (Anderson 221) A few years after the heart catheterization program was instituted, French also instituted a heart surgery program. (Harvey, 1653) Mr. Anderson noted that they regarded the service as one which would give the hospital increased census since it was not available elsewhere. (Anderson, 222) SLO General competed to a limited extent by offering facilities for natural childbirth. Many patients desired this type of service (Boyd, 420) and, as a result, most deliveries in the county were done at that hospital. (Bernhardt, 1242; Anderson, 265)

157. Dr. Lave noted that hospitals compete through public relations, particularly by offering their facilities for various meetings and community activities:

> They tend to see the hospital not as this formidable place where you go to die but

> instead [as] a place where you feel more comfortable with. And then, when their physician asks do you have any hospital preference or simply says I will hospitalize you, the patient will say I prefer to go to hospital X.

(Lave, 830) Evidence shows that both French and Sierra Vista competed in this manner. French hired a public relations manager who began a series of educational seminars for patients on health issues. Mr. Friedmann stated that he believed that this would increase the number of patients for the medical clinic group and that "a direct derivative would be . . . that the hospital would get maybe additional census because the physicians now saw a greater number of patients than they did previously. . . ." (Friedmann, 1586) Sierra Vista also engaged in such educational programs. Sierra Vista had an auditorium which was used by a number of organizations for educational programs. (*See* CX 317B; CX 319B) Furthermore, Sierra Vista started its own series of programs similar to that at French. In one report Mr. Carlson noted that the hospital was beginning "a series of educational programs for the community under the direct sponsorship of the hospital. The majority of programs held in the hospital have been sponsored by the various agencies putting on the programs; however, I feel that additional areas of interest to the public should be addressed by the hospital." (CX 318B)

158. Prior to AMI's acquisition of French, a number of different types of third-party payors covered the medical expenses of residents of San Luis Obispo. Some patients were covered by third-party payors which reimbursed hospitals on the [71] basis of the hospital's reasonable costs. (Mittelstaedt, 1167; *see* Derzon, 1994–96) Such cost-based payors included Medicare, Medi-Cal and Blue Cross of Southern California. (Guy, 610; RX 5435Z41; RX 5436Z44) Those payors not cost-based reimburse hospitals on the basis of actual charges. (Mittelstaedt, 1168) In addition, there are several employers in San Luis Obispo County that are "self-insured." (F. 183) Excess capacity was high in San Luis Obispo County which should create a competitive situation. (Lave, 823; *see also* Guy, 660) In 1978, the average occupancy at hospitals in the county was 54.2 percent. (RX 5835) The occupancy at French was 48.1 percent, far lower than the 65 percent rate at Sierra Vista. (*Id.*) Furthermore, there is evidence that the recessionary economy was resulting in lower admissions to local hospitals as patients put off some discretionary surgery. (*See* Carlson, 1364–65) Thus, the possibility existed that hospitals might well have considered giving one of the self-insured groups a discount in order to get its business, as has happened in other areas. (*See* F. 116) As other alternative purchaser programs, such as HMOs and the new state Medi-Cal program began or expanded, hospitals in San Luis Obispo County, and

French in particular, might have felt pressure to compete for that business. (*See* F. 113–122)

159. Hospitals cannot institute certain new services or purchase some equipment without first acquiring a certificate-of-need. (Lave, 830; *see* F. 84) Since the number of CONs that will be granted can be limited, hospitals often compete to be the first to get a CON and thereby get a competitive advantage. (Lave, 831) Competition for CONs took place in San Luis Obispo. In 1975, French set up a heart catheterization program.[16] (Harvey, 1650) This program gave French a competitive advantage. (*See* Anderson, 222) AMI recognized that such a program was advantageous to French. AMI might have considered beginning such a program had it not purchased French Hospital. In noting the advantages of buying French, for example, one memorandum states that the acquisition "would remove the need for Sierra Vista to develop a competitive service." (CX 38C) Had Sierra Vista attempted to start either a heart catheterization lab or a heart surgery program, it would have had to obtain a certificate-of-need. (Harvey, 1687) It is unlikely it could have received one, however, since the services at French were underutilized. (*See* CX 1064 at v 48, v 53; Harvey, 1659) **[72]**

K. *Evidence of AMI's Intent in Purchasing French Hospital*

160. After the doctors purchased French in 1976, there were increasing efforts to increase the census at the hospital. (Boyd, 369–70) To that end, the partners brought in new doctors to the French Clinic and the hospital. (CX 56F; F. 143) In addition, French cut charges for some of its services (F. 155) and added some new services. (F. 159) These changes apparently had effect. In 1978, French's average occupancy was 48.1 percent, as opposed to 46.8 percent the year before. (RX 5835) This increase is significant in view of the fact that the average length of stay was declining. (*See* CX 56F–G) For the first four months of 1979 occupancy was 49.6 percent, even though the average length of stay had declined. (CX 56G) During that period the number of admissions had increased 11 percent over what they had been during the first four months of 1978. (*Id.*)

161. AMI officials were aware of the moves of French Hospital and were concerned about them. In June 1978, after French partnership offerings were made to some doctors in the city (F. 143), Mr. Carlson, the administrator of Sierra Vista, reported to Mr. Loftin, who at that time was Vice-President and Director of AMI's Western Region, that "[a]n unknown factor in physician utilization of the hospital is the increasing number of physicians who have been invited to buy into

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[16] French actually received a certificate-of-exemption rather than a certificate-of-need. (CX 109A–F; Anderson, 221–22)

French Hospital." (CX 317B) In December 1978, after an offering was made to a second group of physicians, Mr. Carlson again noted his concern. He wrote to Mr. Loftin:

> A problem of major concern is that of competition from French Hospital. Because of doctor ownership, past increases in the number of physicians and possible future additions to the Clinic makes [sic] that hospital an increasingly formidable competitor for the limited number of patients in the area. Although the census has remained at approximately the same level, additions to the Clinic could have significant adverse effects on Sierra Vista Hospital.

(CX 318B) Mr. Carlson was concerned that patients who went to doctors at the French Clinic would now be admitted to French instead of Sierra Vista. Mr. Carlson testified:

> I was concerned because if additional physician owners were included at French Hospital that they would have an incentive to admit patients, their patients to that facility, and they would be **[73]** patients that perhaps would have been seen at Sierra Vista.

(Carlson, 1329)

162. One doctor who practiced at Sierra Vista also was concerned about competition from French, and he conveyed his concern in a letter to Mr. Loftin, with a copy to Mr. Carlson. In January 1979, this doctor noted:

> It is also becoming apparent that this hospital [French] is attempting to generate competition in the way of decreased surgery operating room fees, decreased hospital room fees and decreased laboratory and emergency room fees, and thus is became [sic] extremely competitive with Sierra Vista Hospital.

(CX 737) The doctor urged AMI to consider "the possibility that [a] decrease in fees [by Sierra Vista] to be competitive would be in order. . . ." (CX 737) Mr. Loftin also feared that Sierra Vista could lose patients to French (Loftin, 1538) and, in replying to the doctor's letter, he indicated that he, too, was concerned with French's competitive moves. (CX 738) Other services offered by Sierra Vista faced competition from French. Sierra Vista operated a reference lab prior to the acquisition. The lab was slow to get business, however, due to "a number of factors including prices from both local competitors and the major labs in Los Angeles." (CX 452B) One such "local competitor" was French Hospital, which subsequently established a price schedule lower than Sierra Vista's. (CX 319B) In January, 1979, Mr. Carlson noted that Sierra Vista would "need to take action soon to combat this development." (CX 319B)

163. In September, 1978, Mr. Carlson learned that French Hospital was for sale and he communicated that information to Mr. Jim Mus-

ka, who was involved with the acquisition of hospitals for AMI. (Carlson, 1339) Mr. Carlson, who earlier had expressed concern about some of French's competitive moves, indicated that he favored an AMI acquisition of French. (Loftin, 1548) Mr. Muska was an Assistant Vice President who reported to Mr. Loftin and Mr. Danko, both of whom were Vice Presidents. (Loftin, 1541, 1553) Mr. Friedmann, who handled negotiations for French, also contacted Mr. Loftin. (Loftin, 1500) On January 25, 1979, Mr. Loftin, then a Vice-President of AMI and director of the company's Western Region (Loftin, 1476–77), requested that a general letter of intent be issued for the purchase of French Hospital. (*See* CX 38B) The letter of intent binds the company, with a few possible exceptions, to purchase the hospital. (Reilly, 1859) Mr. Loftin's request was **[74]** made to the Contract Development Committee (CDC). (CX 38B) The CDC, which consisted of all but one of the members of the corporation's Executive Committee, met on a weekly basis to review development projects. (Weisman, 1734–35) The CDC then submitted proposals for approval to the Executive Committee or in some cases to the entire Board of Directors. (Reilly, 1832) Mr. Friedmann, who negotiated on behalf of the owners of French, had informed Mr. Loftin that National Medical Enterprises was also interested in the hospital. (Friedmann, 1593) Although negotiations with NME may actually have broken off prior to the beginning of discussions with AMI, Mr. Friedmann never informed AMI officials of this. (Loftin, 1508; Friedmann, 1627) Mr. Loftin's request for a letter of intent to purchase French was clearly motivated, at least in part, by his fear that if AMI did not move quickly, National Medical Enterprises, the owner of Twin Cities Community in Templeton and the fourth largest proprietary hospital chain in the country (CX 608), would purchase French Hospital. Mr. Loftin wrote:

> We do know that National Medical Enterprises is also currently interested in French and that preliminary discussions have been held. Due to this fact, we would like to proceed as soon as possible.

(CX 38B)[17] An anticompetitive intent of AMI also is suggested in another contemporaneous document written by Mr. Loftin. In replying to the doctor who wrote to him concerning the increasing competition from French (F. 162), Mr. Loftin wrote:

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[17] Mr. Loftin, in testimony during this proceeding, explained his statement in CX 38 concerning National Medical Enterprises as follows:

> In my discussions with Mr. Friedmann and other members of the partnership, there was quite an interest in pushing this process as fast as possible; that if AMI was not going to buy it, then most certainly it would have been unfair to drag it on if there was even a small potential that one of the other companies might be interested. (Loftin, 1509)

> We have been aware of the competitive moves of French Hospital and will certainly work to counteract these. **[75]**

(CX 738) Mr. Loftin knew at the time he wrote this letter that AMI was negotiating to purchase French. (*See* CX 38B) In fact, by the time he wrote his reply he had already requested that a letter of intent be issued. (*Compare* CX 38B *with* CX 738)

164. On February 9, 1979, Mr. Dennis Danko, a Vice President of AMI, who had the responsibility "to identify potential acquisitions" for AMI (Loftin, 1514), wrote a memorandum to the CDC which indicated that AMI should purchase French "thus controlling health care services,. . . ." (CX 41D) Mr. Danko also referred to the anticipated $11 million purchase price as "a premium price" which he thought could be justified. He wrote:

> [W]ith the French acquisition, AMI would become the prime, if not the only, provider of health care services in the area. This may be viewed by some in the medical community and others negatively. However, in the long run the positives would overcome the negatives. There also exists a real possibility that with or without French, the local county-owned hospital (114 beds) may close. Currently, one-half of its bed complement is not in operation; it has lost its JCAH accrediation [*sic*]; and the county is supposedly subsidizing the hospital in excess of $1.0M/yr. Note that this hospital is predominately providing O.B. services at this point, plus hemo.
>
> While it is true that if we do not acquire French, our health care centers in the San Luis Obispo County region will continue to operate on a viable basis; however, we face a choice of paying a premium price, thus controlling health care services, while meeting our earnings expectations, or continue to struggle to capture basically the same patient load with French, or another operator such as N.M.E., who may purchase French. It would be my recommendation that we proceed with the acquisition as outlined.

(CX 41C–D) Mr. Danko's memorandum was sent to the CDC,[18] which was composed of members of the corporation's Executive **[76]** Committee, which along with the Board of Directors, approved the acquisition. (Weisman, 1735)

165. Mr. Danko, a Vice President of AMI at the time of the French acquisition, was "responsible for the identification, analysis and acquisition of community hospitals throughout the United States." (CX

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[18] Mr. Weisman, President of AMI who was also a member of the Board of Directors and a member of both the CDC and the Executive Committee, indicated he would have seen this memorandum. (Weisman, 1710, 1734, 1740) Mr. Weisman testified in this proceeding that in making the statement about "controlling health care services" in San Luis Obispo, Mr. Danko probably meant:

> I think what he was talking about was, in essence, flowing from what local health planning and what our own people had been thinking, in terms of the strained utilization levels at Sierra Vista, the underutilization level at French, the ability to take these two circumstances under a common ownership and in a controlled environment and create an infinitely better situation thereafter, as I have discussed a few minutes ago, than presently existed.

(Weisman, 1741)

4A)[19] Analysis of possible acquisitions, such as that contained in CX 41, was clearly one of his responsibilities. The French acquisition was one of seven acquisitions in which Mr. Danko participated at AMI. (CX 5) At the time of the French acquisition, Mr. Danko served as a liaison between the regional directors and the CDC, which had ultimate responsibility for recommending that acquisitions be approved. (Reilly, 742) In the course of his duties, regional directors often submitted information to Mr. Danko for his review. (*See, e.g.*, CX 38C; CX 49B) Mr. Danko was at one **[77]** of the first meetings held with Mr. Friedmann concerning the acquisition of French, and he was present at subsequent meetings as well. (Loftin, 1501; CX 28B, D) Mr. Danko continued to be involved throughout the negotiations. (CX 54A; Loftin, 1547) A number of important memoranda concerning the acquisition were sent to Mr. Danko, as well as to Mr. Loftin. (CX 34B; CX 35A) Mr. James Muska, who was also involved in the acquisition of French, had a dual reporting role to both Mr. Loftin and Mr. Danko. (Loftin, 1553) Mr. Danko ultimately signed the letters of intent requested by Mr. Loftin. (*See* CX 59; CX 60) The letters of intent were important since signing of the letters indicates that "the deal for all practical purposes has been brought to a significant percentage of its fruition." (Reilly, 1859)

166. Mr. Loftin, as did Mr. Weisman (*see* n. 18, *infra*), attempted to show that Mr. Danko's opinion as expressed in CX 41 should be accorded little weight. (Loftin, 1511–14) Mr. Danko's memorandum was clearly within his responsibilities. (CX 4A; F. 165) Both Mr. Loftin and Mr. Danko were AMI Vice Presidents at the time of the acquisition. (Loftin, 1511) Although Mr. Loftin made more money than Mr. Danko (Weisman, 1737), he also had been with the company longer than Mr. Danko. (CX 4A; CX 61) Furthermore, Mr. Danko was given a raise by the Board of Directors shortly after the French acquisition closed (*see* CX 6D), so there is no indication that the company was displeased with his work.

167. The consideration for AMI's purchase of French Hospital and related assets was $10,970,000. This included the 220,225 shares of stock, with a fair market value of approximately $6.5 million, and the assumption of approximately $3.9 million in long-term debt. (F. 10) (RX 581B–D, H–Y; Loftin, 1508, Friedmann, 1594–95) Included in the acquisition was a CAT scanner and other x-ray and laboratory equipment purchased from French Medical Clinic, Inc. (F. 10) This equipment was purchased to be used with AMI's operation of the hospi-

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[19] Mr. Danko resigned at the same time that responsibility for analysis of acquisitions was shifted to the new Corporate Development staff, headed by Mr. Reilly. (Reilly, 742–43) There was some overlap in Mr. Reilly's responsibilities and Mr. Danko's since an AMI report expressed concern that "there be no slippage during the transfer of responsibility from Denny [Danko]" to Mr. Reilly. (CX 1027F)

tal.[20] (*See* F. 9) [78]

168. Mr. Danko, in his February 9, 1979 memorandum, stated that the price paid by AMI for French was a premium price:

> In summary, I view French as a viable, productive acquisition. The $11.0 million purchase price for the hospital equates to nearly $80,000/bed, a premium price. However, the necessary bottom line can be met and exceeded.

(CX 41C)

169. In reviewing the transaction, reference is often made to the "net equity price." This term refers to the value of the AMI stock given in connection with the transaction. (Loftin, 1549) Thus, the net equity price of the French acquisition was $6.5 million dollars. (*See* RX 5851D)[21] This is at least a million dollars more than AMI's analysts recommended paying. On December 11, 1978, Mr. Lossett, Financial Director of the Western Region and an Assistant Vice President of AMI (CX 12Z21), wrote a memorandum to Mr. Loftin after reviewing various financial information about French. Mr. Lossett reported to Mr. Loftin, was generally responsible for putting together financial analyses, and produced work upon which Mr. Loftin would rely. (Loftin, 1549) Mr. Lossett concluded that "the acquisition of French Hospital is a viable proposition on a net equity purchase price between $4 million and $5 million dollars." (CX 33A)[22] About a week after Mr. Lossett wrote his memorandum, Mr. Muska also put together a memorandum reviewing the financial statements of French Hospital. (CX 35A) Mr. Muska, an AMI Assistant Vice President at the time (Loftin, 1544), suggested a net equity purchase price of approximately $6 million, still lower than the net equity price actually paid by AMI. More importantly, Mr. Muska included not only the hospital in this estimate, but also the French Clinic and the Atascadero Clinic, neither of which were ultimately purchased by AMI. (CX 35A, H) By April, Mr. Lossett had a chance to review more information about the hospital and had identified certain areas which constituted "either a problem or a deteriorating trend." (CX 49I) As a result, Mr. Lossett cautioned against paying too much for the hospital. He stated that the "hospital appears to be an excellent buy at a net equity price of $5.3 million. It [79] is less attractive at $6.3 million." (CX 49K)[23] Ultimately, AMI paid $6.5 million net equity price. (RX 5851D) Respondents argue that the "tentative acquisition price"

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[20] According to state health planning documents, in 1978 more than half of the CAT scans performed at French were on patients admitted to French. (RX 5469Z243) After the acquisition, a substantial number of CAT scans were performed on inpatients. (CX 274H) In fact, AMI advertised that French had a CAT scanner. (CX 91)

[21] This $6.5 million dollar figure does not include the equipment purchased from the Clinic.

[22] This figure did not include the equipment purchased from the Clinic.

[23] The accompanying documents indicate that this price included only the hospital and equipment ultimately bought from the Clinic, not the entire clinic itself. (*See* CX 49)

set forth in Mr. Lossett's memo was $12.43 million (CX 49J), which included $5.3 million in debt assumption. (CX 49Q) In the end, respondents state, AMI paid $10.4 million, including only $3.9 million in assumed debt. Therefore, according to respondents, AMI paid more than $1 million less than Mr. Lossett contemplated. (RB, p. 164) Respondents are quoting only the long-term debt assumed by AMI in the acquisition. Mr. Lossett included in his analysis $1,030,000 in current liabilities and also $400,000 in capital improvements. (CX 49Q) Respondents assumed the current liabilities at the time of the acquisition. (CX 68Z27; CX 59) If you take Mr. Lossett's tentative acquisition price of $12,430,000 and substract $700,000 ancillary equipment, $1,030,000 current liabilities, and $400,000 in capital improvements, the tentative purchase price becomes $10.3 million. (CX 49J, Q) AMI actually paid $10.4 million. (F. 10) Further, Mr. Lossett, on December 11, 1978, had valued the Central Coast Hospital Company equity value at only $4,335,000. (CX 33F)

170. The partners owning French Hospital would have been willing to take substantially less than AMI ultimately paid. In late 1977, approximately a year before the first AMI contacts concerning French, another group, the Vesper Society, had expressed an interest in purchasing French. (*See* CX 21A–B; CX 23) After these negotiations fell through, the owners of French gave Mr. Friedmann a mandate to handle any future negotiations himself and only to come forward with a "true offer." (Friedmann, 1589) As a guideline, the partners told Mr. Friedmann that $150,000 per partnership unit was "the least they would be willing to accept." (Friedmann, 1589–90) The original partners who had bought the hospital in 1976 paid $20,000 for a share (Friedmann, 1630); thus, this "floor price" of $150,000 per unit (*see* Friedmann, 1589–90) would already have represented a substantial appreciation in the shares. Had AMI purchased the hospital for this floor amount, it would have cost $4.96 million, less than half of what AMI ultimately paid.[24] In fact, AMI paid about $315,000 per partnership **[80]** share,[25] more than double the least acceptable price the partnership had indicated it would accept.

171. Complaint counsel prepared a chart showing the cost to AMI of hospital acquisitions it made between 1978 and 1980 for which the purchase price was publicly available. (CX 1034) Respondents added information for French Hospital and other hospitals for which public information was unavailable. (RX 5850) According to these charts, the average cost to AMI of hospitals acquired during this period was

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[24] This figure is arrived at by multiplying $150,000 by 33, the number of full partnership units that existed, according to Mr. Friedmann. (Friedmann, 1603)

[25] This figure is arrived at by dividing the price paid for the shares of the corporation, $10.4 million, by 33 units. This comes to $315,151.52. This figure is corroborated by Dr. Boyd, who stated that he was paid approximately $80,000 for his quarter share, which would translate to $320,000 for a full share. (*See* Boyd, 384)

$67,070. (*Id.*) The per bed cost of French Hospital, including equipment purchased from the clinic, was approximately $79,500,[26] or over $12,000 per bed more than the average price paid by AMI during 1978–1980.

172. Mr. Weisman and Mr. Loftin of AMI testified that in their opinion the price AMI paid for French cannot be described as "premium." Mr. Weisman does not believe the price paid per bed was unusually high compared to the typical per bed price that he has seen. (Weisman, 1734–35, 1740–41) Mr. Loftin testified that he had recommended that AMI pay $600,000 more for the hospital than the $10.4 million price ultimately paid. (Loftin, 1511–13) Mr. Derzon likewise testified that he does not believe that AMI paid a premium price. Mr. Derzon believes that the price was comparable to prices being paid for other **[81]** hospital facilities at about that time.[27] (Derzon, 2047–49; *see also,* Anderson, 273; Friedmann, 1594–95) Mr. Derzon prepared a chart, RX 5803, which showed the purchase price and size of general acute care hospitals acquired between 1980 and 1982. The information contained in RX 5803 came from a trade publication, *Modern Healthcare.* (RX 5803B) Not all hospitals listed in *Modern Healthcare* were included since some did not have the number of beds reported. (Derzon, 2048) Furthermore, *Modern Healthcare* reports acquisitions only to the extent it can get information. (Derzon, 2048) *Modern Healthcare* had no information concerning acquisitions during 1979 when AMI acquired French (Derzon, 2050), although several acquisitions took place during that period. (*See* CX 608; CX 1034) Mr. Derzon did not attempt to find out what AMI paid for hospitals, although that information would have been available to him. (Derzon, 2124–25) Based on RX 5803, Mr. Derzon testified, "My conclusion is that I don't believe that AMI paid a remarkably high price for this hospital and I dare say I don't think it got a steal either." (Derzon, 2049)

173. During 1980 AMI paid more than $79,500 per bed in three separate transactions: AMI purchased Mission Bay Memorial Hospital in San Diego, California for $97,493 per bed; Medical Arts Hospital in Dallas, Texas for $80,801 per bed; and West Alabama General Hospital in Northport, Alabama for $85,256 per bed. During the period 1978–1982, the average cost per bed for all hospitals acquired by AMI was $67,070.[28] (CX 1034; RX 5803; RX 5850) Mr. Danko's memo-

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[26] This figure is arrived at by dividing the total cost to AMI of purchasing the hospital, $10.97 million (F. 10) and dividing by 138, the number of beds at French. (RX 5850) The cost of the equipment purchased must be included in the total price, since the equipment was purchased for hospital utilization. (*See* n. 20, *supra*)

[27] Mr. Derzon has never acted as a consultant to purchasers of hospitals concerning what they should pay for a hospital, nor had he ever been directly involved in the purchase or sale of a hospital. (Derzon, 2127–29)

[28] The $67,070 average price per bed AMI paid for hospitals it acquired from 1978 to 1982 (other than those it acquired in acquisitions of multihospital systems) includes the price of the French acquisition, which probably should not be included since it is the transaction in issue. (CX 1034; RX 5850) Excluding French Hospital, AMI paid $65,954 per bed on average for those hospitals.

randum reference to an $11 million purchase price equating to nearly $80,000 per bed as a "premium" price, also referenced that at that price "the necessary bottom line can be met and exceeded." (CX 41C) AMI is a profit-making entity; its officers and directors are charged with responsibility to provide a fair return on the invested capital of AMI shareholders. (Reilly, 737) Thus, AMI **[82]** was concerned that the acquisition of French Hospital meet its profit objectives. (CX 33; CX 35; CX 38) Contemporaneous documents indicate the French acquisition would meet AMI's profit objectives at the price paid:

> In summary, the acquisition of [French] appears to be a unique opportunity for AMI. It would be immediately profitable, achieve our rate of return objective and provide additional growth.

(CX 38F; *see also* CX 38B)

L. *Competitive Effects of the Acquisition*

174. AMI's acquisition of French Hospital has produced extremely high concentration in the hospital market in both the city and county of San Luis Obispo. Concentration can be measured either by AMI's market share, the market share of the two largest firms in the market, or the Herfindahl-Hirschman Index, which takes account of the market shares of all of the firms in the market.[29] (*See* Lave, 892–93) Market shares for inpatient hospital services can be computed on the basis of hospital beds or inpatient days (Lave, 893), or gross revenues for inpatient services. (*See* Mittelstaedt, 1080–82; RX 5800A–D) Market shares computed on the basis of inpatient days best depict the position of firms in the market. (Lave, 893) Market shares for all general acute care hospital services can be computed on the basis of gross hospital revenues. (*See* Mittelstaedt, 1080–82; RX 5800A-D)

175. Appendix D presents, for both the city and the county of San Luis Obispo, the market share of AMI, the market share of the two largest firms in the city and in the county, and the Herfindahl-Hirschman Index. The market shares and the Herfindahl-Hirschman Index figures listed on the chart are computed on the basis of 1979 inpatient days, 1979 hospital beds, 1980 gross inpatient revenues, and 1980 gross hospital revenues (including outpatient revenues). The Justice Department's Merger Guidelines indicate that the Department is likely to challenge mergers which increase the Herfindahl-Hirschman Index more than 100 points where the post-merger index is above 1800 points. (47 FR 38493, 38497 [June 30, **[83]** 1982]) For the city, the

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[29] The Herfindahl-Hirschman Index is computed by squaring the percentage market share of each firm in the market, then adding up those squares. (Lave, 894) The index can range from a value near zero to an upper bound of 10,000. (Lave, 894)

Index was increased from 3996 to 7097 based on gross hospital revenues; the county increase was from 3518 to 5507.

176. The concentration statistics do not reveal the full extent of AMI's dominance of the market. (Lave, 892, 895) AMI's only competitor in the city of San Luis Obispo is SLO General. It is not a formidable competitor because it is relatively old, smaller than either French or Sierra Vista, and, with the exception of its obstetrics department, lacks the modern and sophisticated equipment, and in some areas the high-quality nursing services, necessary to attract doctors (F. 132, 135), and is preferred by fewer patients than French or Sierra Vista. (Boyd, 358) The only other non-AMI hospital in San Luis Obispo County is Twin Cities. This hospital is small, does not offer the range of services offered by French or Sierra Vista, and is inconveniently located for many residents of the county. (Lave, 896–97; Anderson, 227–28; F. 14, 24, 133) As a result SLO General and Twin Cities do not offer effective competition to AMI's hospitals in San Luis Obispo County. (Lave, 896–97) Because of the substantial barriers to the construction of new hospitals in San Luis Obispo County, particularly by firms not already operating in the area (*see* F. 84–88), it is very unlikely that AMI will face any competition for the foreseeable future other than that offered by SLO General and Twin Cities.

177. AMI's acquisition of Arroyo Grande in 1972, which occurred four years after AMI's acquisition of Sierra Vista in 1968, increased AMI's share of inpatient days in San Luis Obispo County in 1972 from 31.7 percent to 44.7 percent. (CX 613A; RX 5804) Its subsequent acquisition of French further increased AMI's share of inpatient days in San Luis Obispo County from 55.6 percent to 75.5 percent. (F. 175) Apart from market share changes caused by acquisitions, and the replacement of old hospitals with larger facilities, there has been little volatility or fluctuation in the market shares of firms operating hospitals in San Luis Obispo County. (RX 5804)

178. Prior to the acquisition AMI's conduct was restrained to some extent by the fact that French Hospital was available as a non-AMI alternative to patients. (F. 152–155) Subsequent to the acquisition this restraint was lacking. As Dr. Lave explained:

> AMI has tremendous power to maintain its prices, to get its prices and say to other people, well, of course you can always travel many miles at great inconvenience to you and to your family and be hospitalized somewhere else but in the meantime we have this hospital here. [84]
>
> There is quite a substantial price premium that would be associated with their ability to be able to control these three hospitals in the county.

(Lave, 901–02) SLO General will not be able to restrain AMI's ability to charge a non-competitive price because it offers inferior services and thus is not a "hospital of choice" for many patients. (Lave, 896; F. 132, 135) Mr. Danko, in his memorandum of February 9, 1979 recommending the acquisition of French Hospital, noted that if the acquisition were not made, AMI would have to "continue to struggle to capture basically the same patient load with French, or another operation such as [National Medical Enterprises], who may purchase French. (CX 41D)

179. AMI's ability to charge a non-competitive price will have an adverse impact on patients and insurance companies. A small percentage of patients pay their own hospital bills (RX 5638); other patients pay part of hospital charges as a result of deductibles and co-payment provisions in their health insurance policies (*see* F. 96, 106, 158); many insurance companies pay for services on the basis of what hospitals charge. In fiscal year 1981, 46.2 percent of the revenues French collected, and 42.8 percent of the revenues Sierra Vista collected, were attributable to self-pay patients and insurance companies. (CX 1033) These individuals and companies can do little to avoid paying excessive hospital charges. (Derzon, 2013–14) As a result of AMI's power over price, AMI now has less incentive to operate its hospitals efficiently. (Lave, 902) Third-party payors that reimburse hospitals for their costs of providing care (including Medicare, and to some extent Blue Cross) may have to pay more for hospital services provided by AMI, especially since AMI's acquisition of French increased the cost basis that can be used in computing hospital costs.

180. Prior to the acquisition, AMI hospitals and French Hospital engaged in various forms of nonprice competition to attract physicians and their patients, or to retain the patronage of those physicians and patients already using their facilities. (F. 134–158) With the French acquisition, these hospitals no longer compete against each other in this way. The administrator of French after the acquisition, Mr. Lauran Bowytz, recognized that such competition had ended. In 1980, he was interviewed by a representative of AMI subsidiary Friesen. (CX 730G-I) He noted that he cannot compete along traditional lines, such as by recruiting doctors, or "steal[ing] from S[ierra] V[ista]" because "competition is AMI." (CX 295W) An AMI Quality Assurance Report for Sierra Vista also recognized that competition between Sierra Vista and French would be curtailed: **[85]**

> For many years Mr. Carlson and his forces have challenged the French Hospital and won the battle, now *that* activity has to be curbed and a balance of cooperation mixed with healthy competitiveness has to be reached. . . .

(CX 425F) (Emphasis in original)

181. Prior to the acquisition, the hospitals in San Luis Obispo competed by exploiting their strengths and developing those aspects of their services in which they had a "comparative advantage" over the others; the result of this was to give patients a choice between hospitals with different strengths and weaknesses. (*See, e.g.*, F. 140, 142) As a result of the elimination of competition between AMI hospitals and French, physicians lost some of their "leverage" to promote improvements in hospital services. As Dr. Lave explained:

> Up until the acquisition, French offered [a] major point of threat, a major one that physicians practicing outside of French, at Arroyo Grande or Sierra Vista, or [San Luis Obispo] General could use on their hospital administrator in order to induce some kind of change, some improvement in behavior. Those effects are very important effects in terms of non-price competition and they were terribly important in disciplining hospital administrators in other hospitals. And when French was acquired a lot of that went away.

(Lave, 899–900)

182. The existence of French as a non-AMI option for Arroyo Grande's physicians allowed them to bring pressure on the administration of Arroyo Grande to upgrade equipment and facilities. (Schwam, 586–87) AMI itself recognized that this leverage existed. (CX 197G, N) With the acquisition of French, the physicians could not threaten to take patients to French if the physicians were dissatisfied with Arroyo Grande. (*See* Schwam, 585) Dr. Schwam explained:

> So [I] and other members of the medical staff felt that having French Hospital as an independent entity was valuable in keeping our hospital—I won't call it up to the state of the art, [it is] still really quite behind—but at least keeping it roughly in range. When French Hospital was acquired by AMI that leverage was lost.

(Schwam, 585–86) [86]

183. AMI's acquisition of French deprived various group purchasers of hospital services of much of their leverage in negotiating discounted charges and other concessions with hospitals in the San Luis Obispo area. HMOs, employers who are self-insured for employee health benefits, and preferred provider plans can act as group purchasers of hospital services, and have negotiated discounts with hospitals in California. (F. 116) Several large employers in San Luis Obispo County are, or soon will be, self-insured completely, or in substantial part, for employee health benefits. (Guy, 694; CX 555A,Z1–Z2; CX 557A-B; CX 561A-B, F; RX 5435Q) One of the non-governmental employers, TRW, Inc., uses an insurance company to administer its benefits plan. (*See* CX 561) Another is Sears, Roebuck & Co., which insures for some of its employee health benefits with its subsidiary, Allstate Insurance Co. (*See* CX 555) While there are no HMOs currently operating in San

Luis Obispo County (Schramm, 2310), one did operate there at one time (RX 5435Z10), and it is possible that another HMO could come to San Luis Obispo in the future. In addition, recent California legislation permits the Medi-Cal program, Blue Cross, and private insurance companies to negotiate prices with hospitals. (F. 123) When these organizations negotiate with hospitals in the San Luis Obispo area, they will be in a much less favorable bargaining position than they would be if AMI had not acquired French Hospital. (Lave, 901) In fact, Friesen has noted "HMO Formation" as a threat to AMI's hospitals. (RX 5435Z52)

184. AMI's ability to hinder the California Medi-Cal program by preventing or impeding the negotiation of cost-saving contracts with hospitals in the San Luis Obispo area is illustrative of the injury possible to group purchasers of hospital services.[30] Had AMI not acquired French Hospital, the state Medi-Cal negotiator would have had three hospitals to negotiate with in the city of San Luis Obispo. Thus, the state would have had some leverage in negotiations and could have created some competition among the hospitals. (Guy, 667–68) French Hospital's very low occupancy rate (RX 5835) would have given the hospital an incentive to outbid the other hospitals in **[87]** order to get a Medi-Cal contract. Mr. Guy, California's Medi-Cal negotiator, described how a hospital's low occupancy rate enhances the state's bargaining position:

> Obviously if the hospital has a low occupancy they are a prime candidate [for a Medi-Cal contract], all other things being equal, because they have the capacity and obviously would have some desire for a larger patient flow.
>
> It is the basic desire for the patient flow that creates the strongest issue in negotiation. Are you prepared to give up patients? Are you prepared to keep the same number of patients or would you like additional patients? Obviously a hospital with a low occupancy would usually prefer additional patients. And, as a result, automatically creates a leverage in negotiation.

(Guy, 660) Mr. Guy, who was generally familiar with the hospitals in the San Luis Obispo area (Guy, 665–66), and had conducted a preliminary review of the area with his staff (Guy, 688–90), concluded that AMI's acquisition of French Hospital may have left the state in a position where any attempt to negotiate Medi-Cal contracts in the area would be pointless:

> Q. How, if at all, does AMI's ownership of those three hospitals in [San Luis Obispo] county affect your negotiating posture?

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[30] Respondents argue that the Medi-Cal contracting plan is likely to fail because of the hardships it will impose both on hospitals and on patients. (Derzon, 2022–27; Schramm, 2312–13) This is opinion only, and is contrary to the expectations of the State of California.

> A. As it deals with the two hospitals out of the three in the City of San Luis Obispo, it makes it extremely difficult to think in terms of negotiation, because there, frankly, is not a competitive base.
>
> Since the City of San Luis Obispo is the largest unit within that area it would appear that negotiation in that area would hardly be productive for the state and, therefore, would tend to eliminate the possibility for any meaningful negotiations within the entire area.
>
> Q. When you say it appears it will not be productive for the state, what do you mean?
>
> A. Well, if the major facilities which you need in order to meet the terms of the law are owned by a single entity, you hardly have an opportunity for competition. Competition is what we need within [88] the negotiating environment to drive the most cost-effective rate for the state.
>
> If it appeared that all we were going to be involved in from the state level was an exercise, then our time would be better spent somewhere else. And in San Luis Obispo it would appear that it would be an exercise; therefore, we would not attempt a negotiation there. We have nothing to negotiate with.

(Guy, 666–67)

185. Mr. Guy's assessment of the state's poor bargaining position in the San Luis Obispo area is supported by a review of the limited alternatives to AMI's hospitals. SLO General cannot supply the number of beds that, according to preliminary estimates, will be required to care for all Medi-Cal patients in the county. (Guy, 688–89) Furthermore, the state will most likely want to contract with at least one hospital in the area other than SLO General to avoid making SLO General a "Medi-Cal hospital." (Guy, 703) SLO General lacks the modern equipment and facilities physicians feel they need to serve their patients. (F. 132, 135) Twin Cities is inconvenient for, and rarely used by, patients and their physicians other than those in the North County area of San Luis Obispo County. (F. 14, 24, 73, 76, 133) In contracting for hospitals to serve the Medi-Cal population in the central and the southern part of San Luis Obispo County, where most Medi-Cal patients in the county are hospitalized (RX 5814), the state will have little choice but to negotiate with AMI. Respondents contend that Mr. Guy is able to negotiate with hospitals in nearby Santa Maria, Marian Medical Center and Valley Community Hospital, to serve San Luis Obispo Medi-Cal patients, and the absence of an independent bid from French Hospital is not reasonably likely to result in a substantial lessening of competition. This is particularly so, according to respondents, since Mr. Guy testified that three hospitals would provide a sufficient competitive base for negotiation. (Guy, 668) The "30-minute access rule" which respondents reference, only sets the maximum distance that the state of California may force a Medi-Cal patient to travel to obtain hospitalization at a Medi-Cal "contracting hospital" (CX 592J–K, U; CX 593); it does not mean that the state will regard any facility within a 30-minute drive as reasonably accessible, or that the Medi-Cal negotiator's threat to force Medi-Cal pa-

tients to use a facility 30 minutes away from their homes will necessarily be a credible threat that enhances the state's negotiating position. Mr. Guy's testimony is contrary to respondents' position. Mr. Guy was interested in negotiating with hospitals in San Luis Obispo County. (Guy, 666–67) **[89]**

186. AMI's acquisition of French also foreclosed the possibility of competition between French and AMI's other hospitals in San Luis Obispo County for certificates-of-need, thus reducing the incentives of those hospitals to promptly respond to community needs, and reducing the options available to health planning authorities as to which hospital should offer a new service or program. (Lave, 900; *see* F. 159)

187. AMI took steps to make charges uniform at all of its hospitals in the San Luis Obispo area after it acquired French. In 1980, for example, a memorandum to administrator Mr. Lauran Bowytz at French Hospital recommended that the charges for certain items be changed. It noted that "these price changes will establish uniformity for the San Luis Obispo area." (CX 301A; *see also* CX 302A) In the Friesen report for French Hospital, Friesen noted as an "action item" to "standardize fee structure for AMI hospitals." (RX 5435Z69) On another occasion, Mr. Bowytz took advantage of the lack of restraint on AMI's pricing conduct by raising charges in order to compensate for a low patient census. (RX 5378AA) In another instance, Mr. Bowytz noted that he was implementing increases for purposes other than to cover certain costs. (CX 51A)

M. *Health Planning Laws and Policy*

188. Congress noted in connection with its finding that "the health care industry does not respond to classic marketplace forces:"

> Investment in costly health care resources, such as hospital beds; coronary care units or radioisotope treatment centers is frequently made without regard to the existence of similar facilities or equipment already operating in an area. Investment in costly facilities and equipment not only results in capital accumulation, but establishes an ongoing demand for payment to support those services. There is convincing evidence from many sources that overbuilding of facilities has occurred in many areas, and that maldistribution of high cost services exists.

(S. Rep. No. 1285, 93d Cong., 2d Sess. 39, *reprinted in* 1974 U.S. Code Cong. & Ad. News 7842 at 7878) In 1979 Congress amended the 1974 National Health Planning and Resources and Development Act ("NHPRDA") in part as follows:

> The Congress finds that the effect of competition on decisions of providers respecting the supply **[90]** of health services and facilities is diminished. The primary source of the lessening of such effect is the prevailing methods of paying for health services by public and private health insurers, particularly for inpatient health services and other

> institutional health services. As a result, there is duplication and excess supply of certain health services and facilities, particularly in the case of inpatient health services.

42 U.S.C. 300k–2(b)(1) (Supp. IV 1980)

> For health services, such as inpatient health services and other institutional health services, for which competition does not or will not appropriately allocate supply consistent with health systems plans and State health plans, health systems agencies and State health planning and development agencies should in the exercise of their functions under this subchapter take actions (where appropriate to advance the purposes of quality assurance, cost effectiveness, and access and the other purposes of this subchapter) to allocate the supply of such services.

Id. at 300k–2(b)(2)

189. Health planning is defined as "a set of assumptions and statistical methods used for the purpose of designing an optimal or rational mix of services for providing health care in a given area." (Johns, 1866) The Federal Government's involvement in health planning began in 1946 when Congress established the Hill-Burton program which was designed to increase hospital construction to alleviate what was viewed as insufficient hospital capacity. (Johns, 1969–71) The building of new hospitals was to be stimulated through a series of grants to the states, which in turn were obligated to prepare plans indicating where there was insufficient capacity. (*Id.*) In the early 1960's, another grant program was instituted which provided funds to local groups of citizens who came together to do voluntary health planning at the local level. (Johns, 1870) In 1965, Congress passed the Comprehensive Health Planning Act which provided funds for comprehensive health planning councils that could be established by local citizens. While establishment of the councils was voluntary, the legislation required that if such councils were established, they had to include consumers as well as health care providers. (Johns, 1870–71) The current system of health planning was established by Congress in 1974 when it enacted NHPRDA. (42 U.S.C. 300k *et seq.* (1976 & Supp. IV 1980); Johns, [91] 1871) This legislation set up a series of mandatory Health Systems Agencies (HSAs) which cover every area in the country. (*Id.*)

190. An HSA is responsible for health planning within each area. (Johns, 1872) HSAs are private, rather than governmental, organizations. Most are set up as independent, nonprofit corporations. (Johns, 1904) Congress required that the HSAs be made up of both providers and consumers, with consumers being the majority. (Johns, 1904) No government official or agency chooses the particular individuals who sit on the board, other than to make a determination that the consumer members are representative of the local population. (Johns, 1905)

In the NHPRDA, Congress required HSAs to perform certain specific functions. (42 U.S.C. 300k–1, 3001–4(c)(1)(A) (1976 & Supp. IV 1980)) These functions are to produce health systems plans; to conduct project reviews, including certificate-of-need reviews; to do "Proposed Uses of Federal Funds" reviews; and to conduct other reviews as requested by other agencies. (Johns, 1872)

191. A health systems plan is a document prepared by the HSA which discusses the health care needs and goals of the health system area. (*See* Bernhardt, 1265) The document is prepared by HSA staff and presented in draft form at public hearings. (Johns, 1873) The document is revised in response to comments received and then is approved by the HSA. (Johns, 1873) It is approved at the state level and then by federal officials who review it for "scope, quality, and consistency with federal planning policies." (Johns, 1873) Health system plans often make general recommendations concerning how certain goals should be achieved. (*See* Johns, 1913–15) The HSA, however, has no power to enforce these recommendations. (Johns, 1913) Furthermore, plans do not make recommendations about specific institutions. (Johns, 1913–14) In fact, with regard to recommendations concerning how excess capacity should be reduced, the plans do not mention specific hospitals by name. (Johns, 1914)

192. HSAs are also required to produce documents called Annual Implementation Plans ("AIPs"). (Johns, 1915) The AIPs are supposed to take the recommendations contained in the health systems plan and discuss when and how they should be implemented. "These recommendations [in the AIP] usually take the form of committees should be formed, meetings should be held, studies should be undertaken and so forth." (Johns, 1915) Like the health system plans, AIPs do not specify which hospitals should undertake any of the steps specified in the plans. (Johns, 1915)

193. The other major function HSAs have is making recommendations on certificates-of-need ("CON") applications. **[92]** Each state is required to have a CON program; before a provider can undertake certain projects, it must first receive a CON. (Johns, 1876–78; F. 84) The granting of a CON represents a judgment by the state that a proposed project is consistent with local needs and state policies. (Johns, 1876) Projects requiring CONs (except in exceptional circumstances) include new hospitals, expansions of bed capacity at existing hospitals (except for small increases by hospitals with high occupancy rates), transfer of beds from one license classification to another, and other major capital expenditures for a hospital. (*See* F. 84) Federal law does not compel states to require a CON for a change of ownership not also involving changes in services or bed capacity. (42 U.S.C.A. 300m–6(d)(1) (West Supp. 1982)) California law expressly exempts acquisi-

tions of hospitals from CON review of capital expenditures. (*Cal. Health & Safety Code* Section 437.10 [Deering Supp. 1983]; *see also* RX 5821Z5; Johns, 1915)

194. Although Congress allowed the planning authorities veto power over the addition of unneeded new health care facilities through the CON process, reductions in unneeded existing facilities and services were to be implemented through the voluntary efforts of providers:

> [T]he apparently modest initial means of implementing health plans, seeking the assistance of individuals and entities in the health service area to do so, is in fact the most important method available . . . [T]he agency must be willing to seek the cooperation of established health entities in the community including physicians, hospitals, and HMOs.

(H.R. Rep. 1382, 93d Cong., 2d Sess. 60. *See* Conf. Rep. No. 1640, 93d Cong., 2d Sess. 69, 73 (1974), *reprinted in* 1974 U.S. Code Cong. & Ad. News 7971 (at 7979, 7983))

195. In California the state planning agency, required by the NHPRDA, is the Office of Statewide Health Planning and Development ("OSHPD"). This office passes on certificate-of-need applications and produces a statewide health plan which makes policy recommendations concerning health care needs of the state. (Johns, 1875, 1881) This office has no power to enforce its recommendations. (Johns, 1913) California also has an Advisory Health Council which performs the functions which the NHPRDA specifies are to be performed by a Statewide Health Coordinating Council (SHCC). Members of the Council are not appointed in the manner prescribed in the federal legislation. (Johns, 1906) California has fourteen HSAs. (CX 533B) HSA 8, **[93]** the Mid-Coast HSA, includes the counties of San Luis Obispo, Monterey, San Benito and Santa Cruz. (RX 5466F-G, T,Z7)

196. The CON process is initiated when a provider submits to the HSA and OSHPD a letter of intent which describes the contemplated project and the magnitude of the expenditure involved. After 60 days, the application for the project may be filed with the HSA and the OSHPD. (RX 5821Z10–Z14; Johns, 1880) The HSA has 45 days to review the application. Usually, the HSA will set up a review panel which will hold public meetings at which the applicant and the agency may make presentations. (Johns, 1880) This panel makes findings with respect to whether the application fulfills the 16 criteria for a CON specified in legislation. (Johns, 1820) The panel's recommendation is reviewed by the HSA which ultimately recommends approval, disapproval, or approval with modification of the application. The HSA's recommendation is then reviewed by the state. (Johns, 1880–

81) The state has several levels of review. A hearing officer reviews the application and takes into account the HSA's recommendation. (Johns, 1881) That decision is then reviewed by the Director of OSHPD who makes the final decision. If he makes a decision different from the HSA's, he must issue a written decision explaining the reason. His decision is appealable, by either the HSA or the applicant, to the state Advisory Health Council. The Council's decision may be appealed in court. (Johns, 1881; RX 5821P, Z25–Z26)

197. The OSHPD and other organizations have consistently noted that extensive excess capacity exists throughout the state. According to one estimate, there are about 10,000 excess beds in the state. (Johns, 1912) In addition, it was also determined that there were excesses in "nearly every conceivable type of service in the state." (Johns, 1912–13) Nearly every HSA notes the existence of excess capacity in its health systems plan and makes some general recommendations concerning its elimination. (Johns, 1915) Excess capacity can be reduced in a number of ways; through conversion of facilities, consolidation of facilities, or closure of facilities. (Johns, 1910) Health systems plans almost never recommend any specific action which institutions should take. (Johns, 1913–15) In most instances where capacity has been reduced, however, it has resulted from the unilateral action of a facility. (Johns, 1926–27)

198. AMI did not consult the Mid-Coast Health Systems Agency (MCHSA) or the HSA which oversees San Luis Obispo County, concerning AMI's plans for French Hospital. Although MCHSA did not have to approve AMI's acquisition of French (Bernhardt, 1275; Johns, 1891), providers often confer informally with HSAs concerning their plans for their institutions. (Johns, 1917) Such consultation is especially common when a hospital is contemplating action which requires a CON. (Johns, 1917–18) **[94]** While AMI's purchase of French did not require a CON, a consolidation of French and Sierra Vista would. (Mittelstaedt, 1097; *see* Johns, 1916) No one from AMI ever discussed its plans for French at any HSA meeting. (*See* Bernhardt, 1296–97)

199. Prior to the acquisition of French, the MCHSA had determined in the 1978–1983 Health Systems Plan and the 1979–1984 Health Systems Plan that excess beds existed and would exist in the future. The 1978–1983 Plan, for example, noted that by 1983, San Luis Obispo County would have an excess of 169 medical-surgical beds (RX 5466Z178); 12 perinatal beds (RX 5466Z275); and 19 intensive care/coronary care beds. (RX 5466Z260) The 1979–1984 Health Plan also found an excess in medical/surgical beds (RX 5467Z190); pediatric beds (RX 5467Z225); intensive care/coronary care beds (RX 5467Z280); and perinatal beds. (RX 5467Z295) MCHSA has long con-

sidered consolidation of services as a solution to the problem of excess capacity. (*See, e.g.*, RX 5460Z39, Z42, Z47, RX 5461Z1–Z6, Z11–Z14, Z30; RX 5462Z11, Z12, Z15, Z17; RX 5466P, Z57, Z181, Z209–Z211, Z265–Z266, Z283–Z285, Z290–Z291) Two MCHSA plans particularly emphasize the point. (RX 5466, the "Health Systems Plan 1978–1983;" and RX 5461, the "Annual Implementation Plan 1979–80")

200. The HSA had no policy concerning how the excess capacity which it identified should be reduced. The primary response of the MCHSA to its finding of excess capacity was to set up a task force to study the problem. (RX 5466Z181) Among the duties of the task force, according to the 1978 plan, were:

> Prepare recommendations for action to reduce excess hospital capacity to include, but not be limited to, consolidation of services and/or delicensure of beds.

(RX5466Z182) The 1979 Plan again points to the task force in response to the problem of excess capacity. (RX 5467Z193–Z194) Dr. Bernhardt, the one member of the Mid-Coast HSA who testified in this proceeding could not remember the task force ever making any report. (Bernhardt, 1296) Another recommendation was directed at preventing future increases in excess capacity. The 1979 Plan stated:

> All inpatient health facilities will be encouraged to consider, before expansions of services or beds the conversion of existing excess resources to fill shortages.

(RX 5467Z181) The 1979–1980 Annual Implementation Plan, which describes how the above recommendation was to be implemented, **[95]** notes that low occupancy at area hospitals will improve "through the Agency's stated policy to encourage conversion of excess beds to services with shortages, as well as mergers." (RX 5461Z63) Dr. Bernhardt, a member of the MCHSA, could not recall any specific discussions of what was meant by this section. (Bernhardt, 1293–94) According to Dr. Bernhardt, " 'merger' wasn't used much at all that I can recall. Consolidation was a term that was predominantly used." (Bernhardt, 1294)

201. Finally, the MCHSA itself did not contemplate consolidation of particular facilities in writing its plans. The annual implementation plans and health system plans never focused on particular hospitals or facilities. (Bernhardt 1273–74) "There were broad discussions about these [bed] excesses. It never got down to specifics in any way at all." (Bernhardt, 1271–72, *see also* Bernhardt, 1268)

202. One of the charges of the task force which was set up was to prepare recommendations concerning delicensure of beds. (RX 5466Z182) Since acquiring French Hospital, AMI has not closed any beds. (Boyd, 426) The consolidation of French and Sierra Vista set out

in the study prepared by Mr. Mittelstaedt for this proceeding (RX 5614; *see, e.g.*, F. 208) also would not result in any reduction in beds. There are currently 138 beds at French and 172 at Sierra Vista. After the proposed consolidation, there will still be the same total number of beds at each hospital. (*See* RX 5614M) Further, no individual service will experience a net reduction in beds; the excess beds will be moved from one hospital to another. For example, in 1985 San Luis Obispo County is anticipated to have an excess of 116 medical/surgical beds. (RX 5469Z21) The proposed consolidation of French and Sierra Vista contemplates reducing the number of medical/surgical beds at French by 18 and increasing them by the same amount at Sierra Vista. (RX 5614L-M) In 1985 there is anticipated an excess of nine perinatal or obstetric beds.[31] (RX5469Z21) AMI proposes to move the 12 existing obstetric beds at Sierra Vista to French. (RX 5614L-M; Bernhardt, 1305) In 1985 there is anticipated an excess of 10 pediatric beds (RX 5469Z21); AMI plans to supplement the 10 beds at French with 6 additional beds now at Sierra Vista. (RX 6514L-M) Finally, in 1985 there is anticipated an excess of 15 ICU/CCU beds. (RX5469Z21) AMI plans no change in the 8 ICU/CCU beds which exist at each hospital. (RX 5614L-M) **[96]**

N. *Efficiencies or Benefits from the Acquisition*

203. Respondents offered evidence that the acquisition of French has created the potential for far-reaching cost savings which could be effected by implementation of recommendations set forth in a study entitled "Cost Savings Expected From Consolidation of French and Sierra Vista Hospitals." (RX 5614A–S) The study indicates that this consolidation could result in annual operating cost savings of at least $12,200,000.[32] In addition to these monetary savings, an enhancement in the quality of care is expected. The study was prepared by employees of AMI and its wholly-owned subsidiary, Friesen, under the direction of Mr. Mittelstaedt, a Vice President of Friesen. (Mittelstaedt, 997–98, 1042–43, 1158) The study was prepared in connection with this proceeding, and AMI's counsel helped formulate the questions to be addressed by the study. (Mittelstaedt, 1042, 1126–27)

204. The study estimated the operating cost savings of consolidation by comparing the unit costs of particular ancillary and support services provided at both hospitals, then assuming that the services could be provided at one location for both hospitals at the lower unit cost. (Mittelstaedt, 1044–45) The study also estimated the costs of personnel whose positions would be eliminated upon consolidation. (Mittel-

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[31] The Plan indicates that obstetric and perinatal beds are the same. (RX 5469Q)

[32] The figures cited for cost savings were derived by taking the figures listed in RX 5614 ($1,242,000 for annual operating cost savings and $12,739,955 for capital cost savings) and subtracting certain amounts discussed by Mr. Mittelstaedt in his testimony. (Mittelstaedt, 1059, 1123–24)

staedt, 1048–49, 1051–52) The largest portion of savings would result because of capital expenditure savings made possible by consolidation. This figure was arrived at by comparing the cost of the capital improvements needed to maintain Sierra Vista as a "first-rate hospital," should there be no consolidation, with the capital costs of consolidating French and Sierra Vista. (RX 5614D–F, R) The anticipated annual operating cost savings of $1,238,000 per year represents a total operating expense reduction of approximately 5 percent, a reduction "completely consistent" with past experience, and "an underestimate" of the savings which could be achieved in this case. (Mittelstaedt, 1052–53, 1123–24; RX 5614K) Further, respondents contend the $1.238 million per year operating cost savings does not include savings which likely will be achieved from increased patient volumes **[97]** arising out of consolidation (Loftin, 1529–31; Weisman, 1744–45; Schramm, 2401–02), and that future cost savings will inevitably occur because there will be no need in the future for two departments to purchase the same equipment where the consolidated patient volume only justifies one. (*See, e.g.*, Stahl, 1406–07)

205. According to respondents, implementation of Friesen's recommendations would result in higher volumes in each of the consolidated specialty areas, which would enhance the quality of care. Higher volumes make it more feasible for a hospital to upgrade its equipment and to recruit and train expert support personnel. Higher volumes also allow physicians and support staff to specialize in a particular area and to sharpen their skills. (Bernhardt, 1279–80; Carlson, 1341–43; Stahl, 1405–06; Loftin, 1529; Harvey, 1674–75; Derzon, 2071–74) The operating rooms at Sierra Vista and French suffer from overutilization and underutilization, respectively. Consolidation would allow the patient load at the two hospitals to be smoothed out, thus solving the utilization problems now experienced at both facilities. This would reduce the space-constrained conditions at Sierra Vista and would allow support staff at French to sharpen their skills through increased experience. (Carlson, 1338–39; Stahl, 1409–11) Consolidation of French and Sierra Vista would result in merger of the two medical staffs, which would allow greater sharing among staff physicians of information regarding the quality of care provided by physicians. (Stahl, 1411–13)

206. The record indicates that consolidation of services between hospitals is unlikely to be achieved without common ownership. As a practical matter hospitals simply are not willing to give up services to other independently-owned hospitals. (Johns, 1899–902; Derzon, 2075–76) Mr. Weisman, AMI's President, and Mr. Loftin, AMI's Vice President, are not aware of any instance in which services at two hospitals not under common ownership have been realigned in a

fashion similar to that proposed by Friesen for Sierra Vista and French. In Mr. Weisman's judgment, it is not realistic to assume that such a realignment could take place in the absence of common ownership because the owner of each facility would be concerned about giving up a valuable service. (Loftin, 1532–33; Weisman, 1758–59) Mr. Derzon knows of no instance in which the type of wide-ranging consolidation proposed by Friesen has taken place between two independently-owned hospitals. The fact that hospitals attempt to preserve their revenue flows and physician loyalties precludes consolidation of important services between noncommonly-owned hospitals. (Derzon, 2075–76) Dr. Bernhardt, a former member of MCHSA, is not aware of two independently-[**98**]owned hospitals anywhere which have consolidated services to the extent described in the Friesen report. (Bernhardt, 1277–78)

207. In approximately June, 1980, Mr. Mittelstaedt was informed that AMI had requested Friesen to study AMI's three hospitals in San Luis Obispo County. Mr. Mittelstaedt was given full responsibility for the project. (Mittelstaedt, 1004–05) RX 5435, RX 5436, and RX 5437 are Friesen's Strategic Plans for the three AMI hospitals in San Luis Obispo County. (Mittelstaedt, 1024)

208. With respect to Sierra Vista and French, Friesen recommended "consolidation of the two facilities under common management while retaining the operation of the two separate physical facilities." (Mittelstaedt, 1027; *see also* Mittelstaedt, 1037–38; RX 5435Z60, Z61, Z66, Z67; RX 5436Z63, Z64, Z70, Z71) Under this strategy, the operations of French and Sierra Vista would be merged under a single administrator and a single hospital name, the medical staffs of the two facilities would be unified into a joint medical staff, and services would be divided "to the extent possible" between the two facilities. Among the services which would be located exclusively at French are pediatrics, obstetrics, clinical laboratory, ophthamology, cardiology, and pathology. Among the services which would be located exclusively at Sierra Vista are trauma, orthopedics, neurosurgery and oncology. Both facilities would continue to provide medical/surgical services as well as intensive care and coronary care services. (Mittelstaedt, 1028; RX 5435Z50, RX 5436Z63)

209. Consolidation of French and Sierra Vista as recommended by Friesen would require the preparation of detailed implementation plans and formal approval of the Executive Committee of AMI's Board of Directors, as well as the Boards of Directors of French and Sierra Vista. (Loftin, 1534–36; Weisman, 1746) According to AMI, this matter of consolidation has not been put to the Executive Committee because of the present litigation. Disentangling the two hospitals in the event they were consolidated and AMI subsequently ordered to

divest French would be costly to AMI. Further, it would disrupt the community. In particular, it would disrupt the physicians who would have oriented their practices in accord with the distribution of services recommended by Friesen, and would then have to readjust in the event of divestiture. (Mittelstaedt, 1021, 1027–28; Carlson, 1343–44; Loftin, 1528–29, 1534–35; Weisman, 1745–46; RX 5378A, B)

210. Complaint counsel contend that consolidation of French and Sierra Vista might not occur, assuming AMI is permitted to keep French Hospital. First, there is no showing that those individuals who would have to authorize the over $8 million for **[99]** the consolidation would act to do so.[33] There is no way of knowing what the view of the Committee or local boards would be as to how the company's money should be spent. (*See* Loftin, 1534–35) Second, AMI management does not always agree with the conclusions of Friesen (Loftin, 2497), nor does it necessarily follow Friesen's recommendations. (Loftin, 2492) Third, a number of practical barriers stand in the way of a consolidation of the scope Friesen recommends. No consolidation on this scale has even been done before. (Derzon, 2075) A number of doctors told Friesen that it was their belief that AMI did not have the "guts" to tackle some of the tough issues associated with a consolidation.[34] (RX 5435Z68; Mittelstaedt, 1100–01) Doctors who currently practice at one hospital will fight the idea of their specialty being moved to the other. (Bernhardt, 1306) Finally, should AMI decide to consolidate French and Sierra Vista, AMI would have to obtain approval from the local HSA and the state before making most of the capital expenditures required to consolidate the hospitals. (Mittelstaedt, 1097) Government approval is subject to a number of contingencies beyond AMI's control, including how much delay there might be before governmental approval is granted or denied. (Mittelstaedt, 1089–99; *see* F. 85, 196) Since consolidation is one of MCHSA's goals, it can be expected that MCHSA will work with AMI at some plan of consolidation, but not necessarily that proposed by Friesen. (*See* F. 202)

211. RX 5614 states that if consolidation occurs, approximately $1.2 million in operating expenses will be saved. It is questionable whether economies of scale, such as are envisioned by RX 5614, can actually be gained through consolidation. Dr. Schramm, respondents' economic expert, has noted that there is inconsistent evidence concerning whether **[100]** economies of scale exist for hospitals. He has noted that "[w]hen combined, existing research suggests that the economies of

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[33] Testimony elicited in this proceeding from AMI's top officials, Mr. Weisman and Mr. Loftin, was to the effect that they would recommend implementation of the Friesen consolidation plan. (Weisman, 1746; Loftin, 1534) Mr. Weisman testified that he would "unequivocally and enthusiastically" support the proposal. (Weisman, 1747)

[34] At the August, 1981 presentation of Freisen's findings and recommendations to the French and Sierra Vista medical staffs, some support was expressed by local physicians for the concept that French and Sierra Vista be consolidated. (Mittelstaedt, 1020; *see* Mittelstaedt, 1028; Bernhardt, 1279–80; Stahl, 1405; Loftin, 1531–32; Harvey, 1674–76) Drs. Stahl and Harvey's specialties would benefit from the proposed consolidation.

scale attached to hospital size and, presumably, to the size of any hospital entity however formed, may be illusive." (CX 1048P) Dr. Schramm also has written:

> [C]onsolidations undertaken to achieve efficiency, economic security, operating surpluses and improved capabilities for meeting future demands may be ill-advised. The consolidation process itself is complicated, costly and uncertain. Those contemplating a merger should recall that the return-to-scale efficiencies expected in many mergers are never realized.

(CX 1048T)[35] AMI did not take any significant steps toward consolidation of French and Sierra Vista services during the 17 months between AMI's acquisition of French and the time it learned of the FTC's investigation of the acquisition. (Mittelstaedt, 1005–06, 1014; CX 1010) After the acquisition was completed, Friesen reported to AMI that consolidation would produce "somewhat, not enormously, potential lower costs," and "modest" increased profitability. (RX 5435C, Z61; Mittelstaedt, 1109) The administrator of Sierra Vista, in an August 1981 [101] memorandum, also indicated that he did not expect major cost savings to be achieved through consolidation:

> It was my hope that our long range plans would permit consolidation of some services with the eventual objective of at least a slight decrease in the rate at which expenses are increasing. Even though such cooperative efforts would not necessarily be of major dollar savings, they would have been at least symbolic of our united efforts to hold down costs.

(CX 1063A)

212. Mr. Mittelstaedt made a number of questionable assumptions in his study which affect his results. To calculate the operating cost savings resulting from consolidation, Mr. Mittelstaedt compared the unit costs of particular services provided at each hospital, then assumed that the service could be provided at one location for both hospitals at the lower unit cost. (Mittelstaedt, 1044) In some instances the service would be moved from the lower cost hospital to the higher cost hospital. (*See* F. 215) There is no explanation why the formerly high-cost hospital will suddenly be able to deliver the service at a new, lower cost. Also, Mr. Mittelstaedt looked only at the unit cost for one year even though information for the preceding year and the subse-

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[35] Dr. Schramm also cautioned that consumers may see less of the benefits of consolidation than of its costs:

> [T]he merger movement [in the hospital industry] must be seen in the light of consumer satisfaction. Clearly, absolute consumer choices suffer as consolidations advance. This is traditionally rationalized by citing reductions in unit prices that follow consolidation. Interestingly, however, prices do not always reflect the savings of consolidation and artificial price settings must be controlled through regulation. The apparent risk in consolidation from the consumer perspective is that prices may not reflect true savings. The costs of consolidation are expressed as both higher market prices and lost flexibility in the market. Moreover, consumers generally are deprived of product choice even though, as is often argued, the quality of products and services may improve.

quent year was available. (Mittelstaedt, 1126) In addition, a portion of the savings are due to more effective purchasing arrangements. (Mittelstaedt, 1049–50) Consolidation is not necessary to achieve these savings; joint purchasing involving separately-owned hospitals is fairly common in California. (Johns, 1920) Furthermore, Mr. Mittelstaedt has not taken into account any difference in quality at either hospital. (*See* F. 218) Although one service may now be delivered more cheaply than it was before, it may previously have been more expensive because the service was of higher quality. In terms of consumer satisfaction, there may be a net loss. Food service would be one example. (*See* F. 218)

213. RX 5614 ignores the cost of capital for the expenditures required to consolidate French and Sierra Vista. Approximately $8.7 million in renovations and new construction (in 1982 dollars) is required to effect the consolidation set forth in RX 5614.[36] If AMI financed the consolidation project **[102]** at 10%, the average cost of capital to AMI (Mittelstaedt, 1214), the annual cost of capital for the consolidation would be at least $870,000. Mr. Loftin acknowledged that capital costs would affect the feasibility of the project. He stated that he could not prepare a financial projection for this project because he did not yet know what the cost of money would be. (Loftin, 1535) RX 5614 also does not consider the cost of depreciation on newly-constructed facilities and renovations built in the course of consolidation. Depreciation is usually treated as an expense. (*See* CX 38H, J-K) Depreciation on the $2,103,400 of new construction[37] over 40 years would be approximately $52,585 per year. (*See* 38J.) If the renovations were also depreciated on the same basis, there would be an additional expense of almost $165,000. The capital expense and depreciation expense will reduce the potential savings from $1.2 million to about $160 thousand.

214. RX 5614 assumes that consolidation of the emergency rooms at French and Sierra Vista would eliminate the need for French's contract with a physician group to provide medical coverage at its emergency room, and thereby save $204,000. (RX 5614H; Mittelstaedt, 1048–49) This savings assumes that the physician group covering Sierra Vista's emergency room, which is also under contract (Mittelstaedt, 1048), could handle an increase in the number of emergency room visits of more than 50%. It also assumes that the Sierra Vista physician group would handle the increase in emergency room visits at Sierra Vista without insisting on greater compensation for its ser-

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[36] RX 5614 estimates the capital expenditures required to perform the consolidation to be $8,160,045. (RX 5614D–E) In fact, the consolidation will cost more since AMI did not include approximately $540,000 required to expand central service space for a consolidated storage facility. (Mittelstaedt, 1059)

[37] This includes the new construction shown on RX 5614 (*see* RX 5614N, P), and also the $540,000 required for the new consolidated storage facility. (Mittelstaedt, 1059)

vices. RX 5614 also states that consolidation would make it unnecessary to have certain supervisory personnel at both Sierra Vista and French (for example, two administrators or two directors of nursing), and so permit the elimination of 12 supervisory positions, with annual savings of approximately $419,000. (RX 5614C–D, J) This estimate assumes that a single supervisor could perform the function previously performed by two supervisors. It also assumes that each supervisor in charge **[103]** of activities at both hospitals (for example, the director of nursing or the x-ray chief) will have an assistant who can routinely exercise responsibility for on-the-spot decisions when the supervisor is not present. (Mittelstaedt, 1132–34) This cost savings projected by RX 5614 would be diminished to the extent that the supervisors and assistants whose responsibilities are increased as a result of the elimination of supervisory positions ask for, and receive, increased compensation for their efforts—a possibility acknowledged by Mr. Mittelstaedt. (Mittelstaedt, 1129–31) Additionally, the annual cost savings through elimination of supervisory positions would be less than the projected $419,000 in the first three years following consolidation, since RX 5614 assumes it would take at least three years to implement the personnel reductions. (RX 5614J; Mittelstaedt, 1108)

215. The projected operating cost savings for laboratory tests ignore the need to maintain two laboratories even after consolidation. RX 5614 projects annual cost savings of $160,000 on the assumption that all laboratory tests performed at French and Sierra Vista could be performed at one laboratory facility located at French. (RX 5614A, H; Mittelstaedt, 1047–48) Mr. Mittelstaedt predicted that switching Sierra Vista's lab work to French will achieve those savings even though French's per unit cost for lab work is much higher than Sierra Vista's. (*See* RX 5614H) Also, as Mr. Mittelstaedt acknowledged in his testimony, it would still be necessary to have a "stat" laboratory at Sierra Vista to perform tests where results are needed immediately. (Mittelstaedt, 1057) Mr. Mittelstaedt's testimony about the economies of increased volume at a centralized facility (Mittelstaedt, 1048) suggests that "stat" tests performed at Sierra Vista will be more expensive after consolidation than before. This added expense offsets some or all of whatever savings might occur by having the remainder of Sierra Vista's laboratory tests performed along with French's tests at French.

216. RX 5614 does not account for the administrative expenses of carrying out the consolidation of French and Sierra Vista, for example, processing a CON application. There would be a great number of decisions AMI would have to make to perform the variety of tasks required by consolidation. (Mittelstaedt, 1134; RX 5435Z68) Mr. Mittelstaedt asserted that there would be no costs to AMI involved in

having its employees spend their time making those decisions. (Mittelstaedt, 1134–35)

217. RX 5614 concludes that consolidation of French and Sierra Vista will permit AMI to save $38,000 per year by consolidating the contracts of the hospitals with outside laundry firms. RX 5614 assumes, without explanation, that the [104] same volume of laundry would cost less under one contract for both French and Sierra Vista than under two separate contracts with the same laundry. There is nothing in RX 5614, or elsewhere in the record, explaining why it is necessary for both French and Sierra Vista to be owned by AMI to gain whatever advantages there may be to joint purchasing of laundry services, nor is there any explanation why this savings already has not been realized by AMI since institution of joint purchasing of laundry services would be simple to commence and to terminate if necessary.

218. RX 5614 concluded that, through consolidation, $89,000 could be saved through purchasing food supplies for French at the price paid by Sierra Vista. (RX 5614H) This conclusion does not take into account the possibility that French uses food supplies of higher quality than those Sierra Vista uses, or offers a menu requiring more expensive food than Sierra Vista uses. (Mittelstaedt, 1113–114)

219. French and Sierra Vista are two miles apart. (CX 736C) RX 5614 does not take into account the costs of transporting personnel and goods between French and Sierra Vista after consolidation. The supervisors listed on RX 5614, some of whom would be in charge of activities at both French and Sierra Vista after consolidation might have to periodically shuttle back and forth between the facilities. It would also be necessary to transport specimens back and forth between Sierra Vista and the consolidated clinical laboratory and pathology department at French (RX 5614), and to deliver supplies from the central inventory facility at one hospital to the other hospital after consolidation. (Mittelstaedt, 1050)

220. In at least one instance, an item of operating cost savings was double-counted in the computation of the total estimated operating savings. The cost savings projected for emergency services at RX 5614H included savings on emergency room supplies—a $4,000 item listed again as a separate operating cost saving at RX 5614I. (Mittelstaedt, 1121–23) Mr. Mittelstaedt conceded that this item was counted twice. (Mittelstaedt, 1123–24)

221. Most of the savings projected in RX 5614 are from capital cost savings, which it suggests, will be in excess of $12.7 million. (RX 5614E–F) This figure represents the difference between the $20.9 million in capital improvements required to maintain Sierra Vista as a first-rate independent hospital if consolidation does not occur, and

the $8.1 million required to consolidate services at both facilities. (RX 5614E–F) As noted above, there are obstacles to any consolidation which may prevent its being completed. Further, if AMI were not **[105]** to spend $20.9 million to renovate Sierra Vista, then no savings would be achieved by consolidating with French instead. There are a number of reasons why AMI may not spend $20 million plus to renovate Sierra Vista. First, there is no proof that such expenditures are necessary. Of the $20.9 million in capital expenditures, over $17 million are expenditures which AMI claims are needed at once. (RX 5614E) However, these expenditures would remedy problems which AMI has left unsolved for some period of time. (Mittelstaedt, 1139–42) All of these problems existed before AMI acquired French, but AMI has not found it necessary to make such expenditures up to this time. Sierra Vista is already a first-rate hospital (Mittelstaedt, 1142), and the changes suggested in RX 5614 supposedly are necessary to maintain it as a "first-rate hospital." (RX 5614R) Mr. Mittelstaedt admitted that more modest changes could be instituted which would maintain the status quo at Sierra Vista. (Mittelstaedt, 1105, 1152) The suggested changes might improve the facility,[38] but one may reasonably question how dire the need for such changes really is. Secondly, assuming *arguendo* that such changes are needed, AMI may not be willing to spend almost $21 million to make them. This expenditure presumably would have to be approved by the corporation's Executive Committee (Weisman, 1746), and this committee may be reluctant to recommend an investment of this size for a hospital which is in an area that "does not present an ideal situation in terms of market growth and development," and where "[g]rowth in the community is not expected to be high enough to justify major capital expenditures across the board of AMI hospitals." (RX 5435Z66) In fact, AMI could probably build a new hospital for less than $20.9 million. In April, 1981, AMI Executive Vice President R. Bruce Andrews told a group of security analysts:

> We are still building hospitals at costs averaging $50,000–$60,000 per bed, fully equipped, particularly in rural or semi-rural areas.

(CX 430Q) Using Mr. Andrews' figures, AMI could build a new Sierra Vista, from the ground up—with the 50 bed addition contemplated by RX 5614—for approximately $13 million, or $7 million less than the proposed renovation of Sierra Vista.

222. AMI would need a certificate-of-need to make the changes envisioned by RX 5614. (Mittelstaedt, 1145) AMI may **[106]** not re-

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[38] AMI's study does not weigh the possible benefits to the public from a "renovated" Sierra Vista versus a "consolidated" Sierra Vista.

ceive approval for such action. California's health planning authorities strive to prevent unnecessary investment in hospital facilities. (*See* Johns, 1883) They will closely scrutinize such a large proposed capital expenditure (Johns, 1879–1883), both as to whether the improvements are really necessary and whether more modest improvements (*see* Mittelstaedt, 1152) would be sufficient. In addition, more than $3.1 million of the proposed capital expenditures, for addition of 50 beds in the late 1980's, may not be approved.[39] San Luis Obispo County is overbedded and is likely to remain so for some time in the future. California's health planning authorities are thus unlikely to approve additional beds in the area. The original Friesen reports for San Luis Obispo noted that the HSA "did not see a need for additional beds in the San Luis Obispo County planning area. . . . Any program involving the addition of beds will be difficult." (RX5435U) It can be expected that the HSA would follow the policy which it had previously announced (CX 1064 at V–22), and withhold approval for additional beds until utilization of existing beds in other area hospitals improved. It is undoubtful whether Sierra Vista's utilization will grow enough, absent consolidation, to require additional beds. Sierra Vista had only a 70% occupancy rate in calendar year 1981, and no consistent trend of increased occupancy during the preceding years. (RX 5835) It therefore has room to grow without having to increase its bed capacity. Also, RX 5614 concludes that the 50 beds are required on the assumptions that utilization of hospital inpatient services will increase as the population grows and that Sierra Vista's share of the area's patients will remain the same. (Mittelstaedt, 1063) The first assumption is suspect given testimony by respondents' witnesses that there is a trend toward decreasing length of stay for inpatients. (Mittelstaedt, 1179) Furthermore, growth in utilization of inpatient services is questionable given the decreasing rate of hospitalization per 1,000 population in San Luis Obispo County (RX 5775), and a slowdown in the rate of population growth in the County. (*See* CX 38Z9–Z16)

223. To the extent that AMI spends less than $21 million to renovate Sierra Vista, the alleged savings realized by **[107]** consolidating are correspondingly reduced. It is in AMI's interest to make these capital costs appear as high as possible to accentuate the supposed savings to be realized from consolidating with French. This could explain some of the inconsistencies between the $20.9 million figure and other evidence in the record. For example, AMI has already applied for a certificate-of-need for a more spacious emergency room

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[39] The cost of those 50 beds exceeds the $3,100,000 estimated at RX 5614S because there would be expenditures during an earlier stage of renovation to "stress" a building to permit addition of the floor housing the 50 beds. (Mittelstaedt, 1063) Should those 50 beds be deleted from AMI's construction plans, it would be unnecessary to stress the building to accommodate those beds.

at Sierra Vista. (Carlson, 1344–45) This project may obviate the need for part of the construction program outlined at RX 5614R–S, particularly the $900,000 temporary relocation of the emergency room and the $11,500,000 for new construction. Secondly, most of the $20.9 million would go for new construction which would cost $160 (in 1982 dollars) per square foot. (RX 5614N)[40] The Friesen reports, which were also overseen by Mr. Mittelstaedt, projected the cost of new construction at $120 per square foot (in 1981 dollars). (RX 5435Z65) It seems unlikely that the $40.00 per square foot difference is due entirely to one year of inflation.

224. AMI states that since the French acquisition, it has implemented a number of shared services among its hospitals in San Luis Obispo County which have resulted in cost savings. (Carlson, 1330, 1347; Loftin, 1521–22) At the time of the acquisition, French had neither echocardiography equipment nor ultrasound equipment. Sierra Vista had relatively new echocardiography equipment but no ultrasound equipment. Arroyo Grande had ultrasound equipment of limited capability but no echocardiography equipment. (Loftin, 1522; RX 5642A) In February, 1980, AMI instituted a mobile echocardiography and ultrasound service for its three San Luis Obispo county hospitals. (CX 454B; CX 455B; RX 5364A; Loftin, 1523–24) AMI purchased a van and ultrasound equipment and moved Sierra Vista's echocardiography equipment from the hospital to the van. (Loftin, 1522–23) The mobile van service was for the most part limited to the three AMI hospitals. From time to time, however, at a physician's request, the mobile van serviced SLO General and Twin Cities. (Loftin, 1524–25; Harvey, 1671–72; CX 456B) The mobile echocardiography and ultrasound services operated over a period of approximately two years. (Loftin, 1526; Harvey, 1669–70, 1673–74; RX 5364A; RX 5613) The service was terminated approximately September 1, 1982 because each **[108]** hospital had developed a demonstrated need for its own ultrasound and echocardiography equipment. (Carlson, 1336–37; Loftin, 1525; Harvey, 1672–73)

225. This mobile van service is not a benefit resulting from the acquisition. In fact, the service may have been impractical. The fact the service lasted only two years before each hospital went back to its own equipment indicates it was of doubtful utility. (*See* CX 1011A–C) More importantly, an acquisition was not necessary for the hospitals to share this service. AMI has a subsidiary whose business is providing mobile diagnostic services, such as were provided in San Luis Obispo County, to hospitals. (RX 5823 at 52; *see* Harvey, 1694)

226. In August, 1980, French, Sierra Vista and Arroyo Grande

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[40] This is the price for new construction needed as part of the consolidation with French. (RX 5614N) It is assumed that the cost is the same for new construction required under the plan to renovate Sierra Vista.

implemented a joint system for maintenance of biomedical equipment. The new program involved the joint hiring of skilled biomedical technicians to service the over 1,000 pieces of biomedical equipment at the three hospitals. (CX 460A; Carlson, 1330–31) Before implementing this service, the hospitals called for a service representative who oftentimes had to travel from Los Angeles or San Francisco. This would lengthen the time that the equipment would be unavailable. Such "downtime" was not only expensive but disruptive and potentially dangerous to patients who needed the equipment. (Carlson, 1330–31, 1337–38) The availability of local biomedical technicians allows the hospitals to operate safely with fewer pieces of redundant backup equipment. (CX 228B) Hospitals in many communities not under common ownership share biomedical equipment repair services, either by jointly operating such a service or (more frequently) by jointly contracting with another firm to obtain the service. (Mittelstaedt, 1102–05) Such an arrangement could have been possible had French not been acquired by AMI.

227. A joint reference laboratory for physicians was established by AMI at French. A reference laboratory is a facility to which physicians send various patient samples from their offices for analysis. (Carlson, 1333–34; Stahl, 1400–01) Couriers are sent to physicians' offices to collect samples and to bring them to the central office at French for processing. They are then transported to the appropriate AMI hospital laboratory—*i.e.*, the laboratory which has the capability to perform the needed test—for analysis. (Carlson, 1333–34; Stahl, 1402) The reference laboratory provides services primarily to outpatients, rather than to hospitalized patients. (Stahl, 1401) It is questionable whether the reference lab is a benefit resulting from the acquisition of French Hospital. The reference lab benefits those patients who have tests in their doctors' offices. (*See* Stahl, 1401) Second, reference labs existed in San Luis Obispo prior to the acquisition. Sierra [**109**] Vista had a reference lab prior to the acquisition. (Carlson, 1333) The acquisition may actually have had a detrimental effect on reference lab services since prior to the acquisition French operated a competing reference lab which had lower prices than Sierra Vista. (CX 319B)

228. Common ownership of French and Sierra Vista has enabled the hospitals to avoid some duplication of services. An example concerns cardiac rehabilitation programs at each hospital. When French established a cardiac rehabilitation program in late 1981 in connection with its developing cardiovascular specialty, Sierra Vista already had such a program. The directors of the French and Sierra Vista programs agreed to minimize unnecessary duplication. It was agreed that French's cardiac rehabilitation program would offer service to

French's inpatients and to all outpatients in the area. Sierra Vista's cardiac rehabilitation program would, by contrast, service only inpatients at Sierra Vista. (CX 331A, B; CX 333C) No estimate of dollar savings is available. The French Hospital administrator merely noted that this type of approach will enable the hospitals to "present a united front when dealing with the lay and medical communities." (CX 331B)

229. French, Sierra Vista, Arroyo Grande, and AMI's hospital in Visalia, California, share computer services. A computer is centrally located at Sierra Vista with terminals at the other three hospitals. Each hospital inputs its financial and patient data and prints its bills from the same computer. This eliminates the need for a separate computer at each hospital. (Carlson, 1332–33, 1353) Respondents do not indicate the amount of savings through having one computer serve four hospitals; nor is it demonstrated why shared data-processing services of the kind offered by AMI subsidiary Professional Hospital Services (RX 5823 at 53) could not achieve much or all of those cost savings without common ownership of French and the other three hospitals. Moreover, the 140-mile distance between San Luis Obispo and one of the AMI hospitals sharing the computer (Carlson, 1332–33) suggests that French could have shared computer services with many multihospital systems that operated hospitals in California.

230. Common ownership of three hospitals in San Luis Obispo County has also enabled AMI to engage in joint hiring. An example is the hiring of a cardiovascular anesthesiologist for French and Arroyo Grande. The anesthesiologist previously associated with French's cardiac surgery team resigned in October, 1981. At that time, Arroyo Grande was looking for additional anesthesiology support. The two hospitals joined efforts and successfully recruited a cardiovascular anesthesiologist. (RX 5377A) Also, AMI has recently expanded **[110]** its purchasing agreement so that savings related to joint purchasing are already being realized (Mittelstaedt, 1051, 1119), and additional savings in this area are expected. (RX 5614)

O. *Evidence Relevant to the Remedy Being Requested.*

231. The Notice of Contemplated Relief served with the complaint included, but is not limited to (1) a requirement that AMI divest the assets acquired in the French Hospital acquisition, and (2) a requirement that for a period of ten years, AMI obtain Commission approval prior to making any future acquisition of any general acute care hospital located within the marketing area of a hospital owned or operated by AMI or one of its subsidiaries.

232. In complaint counsel's post-trial brief, the relief which complaint counsel seeks has been made somewhat more specific. (*See* CB, App. pp. 105–09) Complaint counsel now requests an order requiring

complete divestiture of all assets that AMI acquired from Central Coast Hospital Company, French Hospital Corporation of San Luis Obispo, and French Medical Clinic, Inc., together with any subsequent improvements. The divestiture shall be subject to the prior approval of the Federal Trade Commission. Pending divestiture, AMI shall take all measures necessary to maintain French Hospital in its present condition and to prevent any deterioration, except for normal wear and tear, of any of the assets to be divested so as not to impair French Hospital's present operating abilities or market value.

233. The requirement for prior Commission approval of future acquisitions of general acute care hospitals by AMI also has been made more specific by complaint counsel. Complaint counsel now seek an order that, for a period of ten (10) years, AMI shall not, without the prior approval of the Federal Trade Commission, directly or indirectly acquire any hospital located in the states of Oregon, California, Texas, Oklahoma, Missouri, Arkansas, Louisiana, Mississippi, Alabama, Georgia, Florida, South Carolina, or North Carolina, if:

(1) The hospital to be acquired is within a Standard Metropolitan Statistical Area ("SMSA") in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a twenty (20) percent or more share of the licensed general acute care hospital beds; or [111]

(2) The hospital to be acquired is not within an SMSA but is in a county in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a twenty (20) percent or more share of the licensed hospital beds; or

(3) The hospital to be acquired is (a) not within an SMSA but is within thirty (30) miles of a hospital which AMI already operates in another county, and (b) the hospital to be acquired and any hospital(s) that AMI operates combined have a twenty (20) percent or more share of the licensed hospital beds in the area within thirty (30) miles of the midpoint between the hospital to be acquired and any hospital operated by AMI.

Provided, however, That no acquisition shall be subject to this prohibition if the consideration to be paid for the hospital, including assumption by AMI of liabilities of its present owners, does not exceed one million dollars.

234. In 1980 there were 5,830 community hospitals in the United States with a total of 988,000 beds. Seventy percent of these beds are owned by private, non-profit entities. Another 21 percent are owned by state or local governmental bodies. Only 8.8 percent are owned by for-profit entities. That 8.8 percent includes all hospitals owned by for-profit organizations, such as doctor or other investor groups, as

well [illegible] hospitals owned by for-profit multi-hospital systems such as AMI. (RX 5718; RX 5719) In 1972, 6.5 percent of the beds in community hospitals were controlled by for-profit entities. In 1980, that had grown to 8.8 percent. (RX 5719)

235. The five largest proprietary hospital chains, Hospital Corporation of America, Humana, AMI, National Medical Enterprises, and Lifemark acquired a total of 192 general acute care hospitals in the years 1975–1981. (CX 608; Silvia, 794–95) During their fiscal year 1975, these firms acquired a total of three hospitals; in their fiscal year 1981, they acquired a total of 80 hospitals. (CX 608) Other firms are also engaged in acquiring hospitals. These firms include about a dozen smaller proprietary hospital chains and a number of large non-profit hospital chains. In addition, some large hospitals seek to acquire other hospitals in their local areas. (Weisman, 1720–21; Reilly, 1796–97) Hospital acquisitions are most frequent in the "Sunbelt" area of the United States. The large proprietary hospital chains, including AMI, operate predominately in the "Sunbelt" (Derzon, 2184–86), an area notable for its rapid population growth and its relatively unrestrictive regulation of hospitals. (CX 430J–K: Derzon, 2185; Weisman, 1747–48) [112]

236. AMI currently owns, operates or has under construction 75 hospitals in the United States. (Weisman, 1747–48; but *see* F. 1) Nearly all of these hospitals were obtained through acquisition. (Reilly, 771, 1845; Weisman, 1748; CX 613) AMI has acquired 19 general acute care hospitals since 1980. (CX 613A–D; Reilly, 1845) Furthermore, AMI will continue to grow by acquiring hospitals. In 1980, AMI's president stated that the objective of the company was to acquire between four and six hospitals a year, but that it might make acquisitions at a more rapid rate if the right opportunities presented themselves. (CX 430A, C, L, W) All of the hospitals AMI currently owns, operates, or has under construction are located in the states of Oregon, California, Texas, Oklahoma, Louisiana, Missouri, Arkansas, Mississippi, Alabama, Florida, Georgia, South Carolina, and North Carolina. (RX 5823 at 50–51) AMI has only acquired one hospital not located in these 12 states, and it was subsequently sold. (CX 613A–D) These states are almost all in the "Sunbelt."

237. A hospital typically is owned by one of three groups: a government entity, a non-profit religious or charitable organization, or a for-profit investor group. (RX 5718; Reilly, 753–54) Because of advances in hospital technology and increases in construction costs required for renovating or replacing an aging facility, establishing and operating a hospital of state-of-the-art quality is quite expensive. Local governmental agencies, religious groups or small investor groups sometimes cannot obtain the capital necessary to provide needed health care services and therefore decide to sell the hospital.

(Reilly, 755–56, 1797–99; Schramm, 2351–53; Weisman, 1719–20; RX 5627F, G; *see also* S. Rep. No. 96, 96th Cong., 1st Sess. 87, *reprinted in* 1979 U.S. Code Cong. & Ad. News at 1392)

238. Charles P. Reilly, AMI's Senior Vice President responsible for supervising activities directed toward development of new hospitals and the acquisition of hospitals (Reilly, 1793), testified that he began his position at AMI by submitting a report which indicated AMI was not keeping up with other investor-owned firms in the industry in terms of growth through the acquisition or development of domestic hospitals, and that there were substantial opportunities that AMI was ignoring. (Reilly, 1794–95) He further testified that because of health planning legislation which seeks to limit the expansion of bed capacity and physical plant investment and equipment investment, there are substantially more opportunities to buy hospitals than there are to initiate and charter new ones. (Reilly, 1795) Multi-hospital systems compete to purchase hospitals by offering financial terms and commitments to provide health services and management expertise which meet [113] the community's needs. (Reilly, 1806–08) This competition among multi-hospital systems for acquiring hospitals is intense. (Reilly, 1796; Schramm, 2351; RX 5621; RX 5627)

239. AMI contends that the order sought by complaint counsel is likely to substantially lessen competition among multi-hospital systems for acquisition of hospitals. The bidding and negotiation involved in hospital acquisitions proceed at a rapid pace and effective participation in that process requires the ability to make a firm commitment in a relatively short period. Mr. Reilly, AMI's Vice President, testified that lack of ability to make such a commitment would place AMI at a disadvantage. (Reilly, 1848) Mr. Weisman, AMI's Chief Executive Officer, testified:

> These are circumstances where time is almost invariably of the essence. We have situations with frequency where we will receive what the sellers have a tendency to characterize as an RFP, a request for proposal, literally with time dimensions of seven to ten days, two weeks, three weeks, that kind of thing, with an insistence upon the part of the seller that, having made their decision, they want to expedite and arrive at fruition in the shortest possible time.

(Weisman, 1726–27) A pre-approval requirement would undermine AMI's ability to put forth a firm offer in a timely fashion. AMI's offer would necessarily be conditioned on FTC pre-approval. This would be fundamentally different from the Hart-Scott-Rodino filing requirement or a requirement under state law to obtain CON approval because such requirements are equally applicable to all purchasers. Mr. Weisman testified that hospital sellers "don't view Hart-Scott generally as a condition any more than they view, for example, a preparation of a definitive agreement as a condition." (Weisman, 1727) The pre-approval remedy, in contrast, would apply only to AMI and would place a unique condition upon AMI's offer. (Weisman, 1727–28) Mr. Reilly also testified that a perception by hospital sellers that AMI is subject to special conditions may cause them not to contact AMI initially, even where the order does not by its terms apply, and thus AMI would not have the opportunity to compete. (Reilly, 1851)

240. In contrast to the testimony of AMI officials in this proceeding, AMI stated in its 1981 Form 10-K, filed with the Securities and Exchange Commission, as follows: [114]

> In the opinion of the company's management, divestiture of French Hospital and a reasonable preacquisition screening mechanism would not have a material adverse effect on the Company's business or financial condition.

(CX 18M) The 10-K is signed by AMI's Chairman of the Board of Directors and Chief Operating Officer, as well as other AMI officials. (CX 18Z23–27)

241. Nearly all hospital acquisitions today would fall within the pre-notification requirements of the Hart-Scott-Rodino Act. (Weisman, 1728) Furthermore, in some states, acquisitions of hospitals are subject to the CON laws. In those states hospital acquisitions have to be approved by the local HSA and the state health departments. Extensive evidentiary hearings are required to obtain a CON. (Reilly, 1849, 1861; Johns, 1916; F. 85, 196)

242. The order proposed by complaint counsel would also apply to hospitals leased or managed by AMI, or where AMI attempts to acquire a lease of a hospital or of management control of a hospital. (CB, App., pp. 105–109) AMI currently operates hospitals under long-term leases. (CX 18C–E; RX 5823 at 50–51; *see also* Silvia, 796) A management contract can give the management firm responsibility for running the hospital's day-to-day operations, including decisions as to staffing levels and other personnel policies, and supply and equipment purchases. In at least some cases, key hospital employees (such as the administrator, controller, and director of nursing) are employed by the management firm rather than by the hospital's owners. Even in areas for which the hospital's owners retain responsibility (such as pricing), the management firm may be responsible for making recommendations to the owners, and therefore has some influence over those decisions. (*See, e.g.*, CX 436G–X; CX 439A–N) During the fiscal year ending August 31, 1978, AMI operated five domestic hospitals under management contracts. (CX 11Z8–Z9) Following AMI's acquisition of Hyatt Medical Enterprises and Brookwood Health Services, AMI operated 26 domestic hospitals (including 4 under develop-

ment) under management contracts. (RX 5824 at 18) AMI sold Hyatt's hospital management subsidiary in July 1982. [115]

II. CONCLUSIONS

A. *Summary of the Issues*

The complaint in this matter issued July 30, 1981, charging respondents American Medical International, Inc. and AMISUB (French Hospital) (collectively "AMI"), Beverly Hills, California, with violations of Section 7 of the Clayton Act, as amended, and Section 5 of the Federal Trade Commission Act, as amended. The complaint challenges the acquisition of the assets and related facilities of the proprietary French Hospital ("French") located in the city of San Luis Obispo, California.

AMI is engaged primarily in the owning, operation and management of general acute care hospitals in the United States and in foreign countries; more than 85 percent of its revenues are derived from its operation of such institutions. AMI also provides health care services through subsidiaries to hospitals and physicians, which include medical-technical support services, financial and management services, and health care development services. In AMI's fiscal year 1982, it had total operating revenues of approximately $1.4 billion and net income of $78.8 million. It owns, operates, or has under construction 72 hospitals in the United States and 24 hospitals abroad. AMI is the nation's third largest proprietary hospital chain in terms of domestic hospitals owned. AMI currently owns and operates three hospitals in San Luis Obispo County, California; they are Sierra Vista Hospital ("Sierra Vista") and French located in the city of San Luis Obispo, and Arroyo Grande Community Hospital ("Arroyo Grande") located in Arroyo Grande, California.

AMISUB (French Hospital) is a wholly-owned subsidiary corporation of AMI, and was established by AMI in connection with the acquisition and operation of French.

On July 18, 1979, AMI acquired from Central Coast Hospital Company all of the common stock of French Hospital Corporation. Central Coast Hospital Company at the time of the acquisition was a limited partnership consisting of both general and limited partners, all but two of whom were physicians. The partnership owned the land, buildings, and other improvements relating to French Hospital. Central Coast Hospital Company's wholly-owned subsidiary, French Hospital Corporation, operated French Hospital, owned or leased the hospital's equipment, and held the license necessary to operate the hospital prior to the acquisition. Central Coast Hospital Company leased to

French Hospital Corporation on a long-term basis the property on which [116] French Hospital is located and the improvements on that property, including the buildings housing the hospital's facilities. In the year ending June 30, 1978, Central Coast Hospital Company and its subsidiary, French Hospital Corporation, had total revenues of $8,171,482 and a combined net income of $745,160.

In the same transaction AMI also acquired from Central Coast Hospital Company certain other assets, including the Company's ownership interest in the French Hospital premises leased to French Hospital Corporation. AMI also purchased from French Medical Clinic, Inc.[1] a CAT scanner and other x-ray and laboratory equipment. (CX 70D–F, W, X–Z; CX 78) While the purchase contract designated AMISUB (French Clinic) as the purchaser, AMI paid the entire consideration for the purchase from its own funds. AMISUB (French Clinic) also that day subleased from French Medical Clinic, Inc. space for use as a CAT scanning and x-ray facility and a clinical laboratory. (CX 71A, F)

The total cost to AMI of the transactions described above was $10,970,000. AMI issued to Central Coast Hospital Company 220,225 shares of stock, with a fair market value of approximately $6.5 million, and assumed approximately $3.9 million in long-term debt of Central Coast Hospital Company. Finally, AMI paid $570,000 in cash for the CAT scanner, x-ray, and laboratory equipment (CX 70E, G) purchased from French Medical Clinic, Inc.

At the time of the acquisition there were five general acute care hospitals in San Luis Obispo County: Sierra Vista, French, and San Luis Obispo General Hospital ("SLO General"), all located in the city of San Luis Obispo near the center of the county; Arroyo Grande Community Hospital ("Arroyo Grande") located in Arroyo Grande in the south area of the county; and Twin Cities Community Hospital ("Twin Cities") located in Templeton in the north area of the county.

Sierra Vista, purchased by AMI in 1968, was the largest hospital in the county with 172 acute care hospital beds. Arroyo Grande, which had 79 acute care hospital beds, was [117] acquired by AMI in 1972. SLO General, owned by the county, had 78 acute care hospital beds.[2] Twin Cities, owned by National Medical Enterprises, had 84 acute care hospital beds. French, acquired by AMI in July 1979 from a partnership composed primarily of physicians practicing in the city of San Luis Obispo, was the second largest hospital in the county with 138 acute care hospital beds. With the acquisition of French, AMI controlled 310 hospital beds in the city of San Luis Obispo out of a total of 388 acute care hospital beds (over 79%), and 389 acute care hospital beds out of a county total of 551 beds (over 70%). In terms of 1979 inpatient hospital days, AMI hospitals in the city of San Luis Obispo had a market share of 87.2%, and a county market share of 75.5%. In terms of 1980 gross hospital revenues, AMI hospitals had a market share in the city of San Luis Obispo of 82.4%, and a county market share of 71.3%. (*See* Appendix D)

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[1] French Medical Clinic, Inc. was a professional corporation which owned or leased the equipment used at French Medical Clinic. It was a wholly-owned subsidiary of Central Coast Clinic Company, a partnership composed of many of the partners in Central Coast Hospital Company which owned French Hospital.

[2] SLO General also had 14 psychiatric beds, which are separately licensed and differ from acute care hospital beds.

The complaint alleges, and complaint counsel contends, that the effects of the acquisition of French may be to lessen competition substantially or tend to create a monopoly in the general acute care hospital market in San Luis Obispo County, California, and/or parts thereof in violation of Section 7 of the Clayton Act, as amended, and Section 5 of the Federal Trade Commission Act, as amended. It is further alleged that AMI, through its wholly-owned subsidiaries, has, with specific intent to exclude competitors and maintain the power to control delivery of hospital services, attempted to monopolize and has otherwise engaged in unfair methods of competition in the market for general acute care hospital services in San Luis Obispo County, or parts thereof. This course of conduct and effects are alleged to violate Section 5 of the Federal Trade Commission Act, as amended.

Complaint counsel requests an order requiring complete divestiture of all assets, tangible and intangible, that AMI acquired from Central Coast Hospital Company, French Hospital Corporation of San Luis Obispo, and French Medical Clinic, Inc., together with any subsequent improvements. The divestiture shall be subject to the prior approval of the Federal Trade Commission; pending divestiture, AMI must take all measures necessary to maintain French Hospital in its present condition and to prevent any deterioration, except for normal wear and tear, of any of the assets to be divested. **[118]**

Complaint counsel also seeks an order that, for a period of ten (10) years, AMI shall not, without the prior approval of the Federal Trade Commission, directly or indirectly acquire any general acute care hospital located in the states of Oregon, California, Texas, Oklahoma, Missouri, Arkansas, Louisiana, Mississippi, Alabama, Georgia, Florida, South Carolina, or North Carolina, if AMI already operates such a hospital within the same SMSA, or within the same county, or within a specified area of such a hospital. (*See* CB, App. 105–109)

Respondents' principal contentions are that the National Health Planning and Resources Development Act, 42 U.S.C. 300k–300s (1976 & Supp. IV 1980), depends for its effectiveness on voluntary actions by providers to reduce excess hospital capacity. The local implementing agency, the Mid-Coast Health Systems Agency, had advocated mergers of hospitals to alleviate over-capacity and duplicative hospital services in San Luis Obispo. AMI's acquisition of French and its plans to merge that facility with Sierra Vista were intended and reasonably calculated to advance that goal. Thus, an antitrust exemption in this case is necessary to make the Planning Act work.

Respondents also contend that the antitrust laws, if applied, have not been violated. Because nearly all hospital bills are covered by insurance, neither patients nor physicians are price-sensitive and, as a result, there is not price competition in the hospital industry. This is particularly true in San Luis Obispo where French and Sierra Vista have never competed on price. Moreover, because of physician politics and animosities in San Luis Obispo there was scant non-price competition between the hospitals. Hence, competition could not be substantially lessened, nor market power enhanced by the acquisition. One future effect of the acquisition, according to respondents, is the increased efficiency leading to cost savings and quality enhancement which would result from the merger of French and Sierra Vista, a benefit that Congress sought to promote in the Planning Act.

Finally, respondents submit that the divestiture relief requested by complaint counsel is inappropriate because separate ownership of French and Sierra Vista is not likely to enhance competition in view of the unique economics of the hospital industry. The ten-year prior approval provision is also inappropriate since the record reflects no likelihood that AMI, without such restraint, will engage in illegal conduct. The prior approval provision will dramatically reduce, if not eliminate, AMI's ability to participate effectively in the competitive market for the purchase of hospitals, to the substantial detriment of the communities involved. **[119]**

B. *Jurisdiction*

1. Section 7 of the Clayton Act

In 1979, when AMI acquired French Hospital, Section 7 of the Clayton Act applied only to the direct or indirect acquisition by a corporation of the stock of another corporation, or the direct or indirect acquisition by a corporation of the assets of another corporation.[3]

On July 18, 1979, AMI acquired the assets of Central Coast Hospital Company, a partnership, which included all the common stock of

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[3] Section 7 of the Clayton Act reads, in pertinent part, as follows:

> That no corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly. 15 U.S.C. 18 (1976)

In 1980, the Clayton Act was amended to cover noncorporate acquisitions. Antitrust Procedural Improvements Act of 1980, Pub. L. No. 96–349, Section 6(a), 94 Stat. 1154, 1157–58 (1980).

French Hospital Corporation. Through acquisition of this corporate stock, AMI acquired the corporation operating French Hospital, the state license necessary to operate the hospital, a long-term lease of the hospital building, a substantial amount of equipment, and the corporation's receivables. French Hospital Corporation held a lease from Central Coast Hospital Company under which the corporation had the right to occupy the French Hospital premises until 1991, with an option to renew until 2006. The only assets that AMI purchased from Central Coast Hospital Company, aside from the common stock of French Hospital Corporation, were the French Hospital building, and a vacant lot.[4] Acquisition of the [120] French Hospital Corporation stock gave AMI control of the hospital.[5] The fact that AMI acquired the corporation's stock from a partnership, and not from a corporation does not affect the result.[6] Section 7 does not require that "stock or other share capital" be acquired from a corporation; it prohibits the direct or indirect acquisition by a corporation (AMI) of the stock of another corporation (stock of French Hospital Corporation) where the effect of such acquisition may be substantially to lessen competition or tend to create a monopoly. Thus, AMI's acquisition of the common stock of French Hospital Corporation from the Central Coast Hospital Company, a partnership, satisfies the terms of Section 7 of the Clayton Act in effect in 1979 since it was a "direct or indirect" acquisition of the stock of a corporation.

The critical point in the above analysis is not who had the ultimate control over all the assets, but the fact that French Hospital Corporation, *at the time of the acquisition,* owned or had under lease all the principal assets necessary to the operation of the hospital, and also operated the hospital. AMI acquired the stock of that corporation. Other arrangements could have been worked out to avoid Section 7's proscriptions, such as having the partnership dissolve the corporation and take over the operation of the hospital sometime prior to its acquisition. However, these measures were not undertaken, corporate stock was acquired by another corporation, and Section 7 applies to the acquisition. [121]

AMI's acquisition of French Hospital also included the purchase from French Medical Clinic, Inc. of some equipment, including a CAT scanner and other x-ray and laboratory equipment, used in the operations of French Hospital. This acquisition of corporate assets was an integral part of the transaction which gave AMI control of French Hospital. Section 7 reaches this direct purchase of the corporate assets of French Medical Clinic, Inc., which completed AMI's acquisition of the French Hospital operation.

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[4] The record is not clear as to equipment owned by the partnership and equipment owned by the corporation. (*See* Resp. Reply Brief, p. 190 n.; CX 535; CX 70; CX 60; CX 49B–I; CX 35Z5) However, a precise determination of the equipment owned—or leased—by each entity is not necessary to a resolution of the jurisdictional issue.

[5] Complaint counsel places emphasis on the long-term lease which French Hospital Corporation held on the hospital building. (CB, p. 4; Complaint counsel Reply Brief, p. 61) As respondents point out, if the partnership had desired to amend or change the lease (CX 534Z1), or cancel the lease for that matter, it could have done so at will since the partnership (lessor) wholly-owned and controlled the corporation (lessee). (Resp. Reply Brief, p. 191)

[6] Numerous acquisitions are accomplished through tender offers where the stock is acquired from individuals. No one has suggested, to my knowledge, that such acquisitions are not subject to Section 7 of the Clayton Act.

2. Section 5 of the Federal Trade Commission Act

Section 5 of the Federal Trade Commission Act provides that "[u]nfair methods of competition in or affecting commerce . . . are hereby declared unlawful." 15 U.S.C. 45 (1976). The Commission has applied Section 5 to reach transactions which violate the standards of the Clayton Act, though technically not subject to the Act. For example, in *Beatrice Foods Co.,* 67 F.T.C. 473 (1965), the Commission held that Section 5 could be used to challenge noncorporate acquisitions even though the Clayton Act is inapplicable to such transactions. As the Commission stated in *Beatrice:*

> It is well established that Section 5 reaches transactions which violate the standards of the Clayton Act though for technical reasons are not subject to that Act, unless such application of Section 5 would be an attempt to "supply what Congress has studiously omitted" . . . or to "circumvent the essential criteria of illegality prescribed by the express prohibitions of the Clayton Act" . . . Applying Section 5 to noncorporate acquisitions effectuates, rather than circumvents or conflicts with, Congress' policy with respect to the prevention of anticompetitive acquisitions.

Id. at 726; *see also, Grand Union Co. v. FTC,* 300 F.2d 92, 98–99 (1962).

Section 5 of the Federal Trade Commission Act applies to the entire acquisition transaction which gave AMI control of French Hospital. Because the acquisition of partnership as well as corporate assets can be challenged under Section 5, it is not necessary to predicate Section 5 liability on satisfaction of the technical requirements of Section 7 of the Clayton Act. "[T]he Commission's power to challenge noncorporate acquisitions under Section 5 is well-settled." *Ash Grove Cement Co.,* 85 F.T.C. 1123, 1167 n. 61 (1975). [122]

3. Interstate Commerce

a. *Section 7 of the Clayton Act*

At the time of the French acquisition, Section 7 of the Clayton Act applied to mergers only if both the acquiring and the acquired firms were "engaged in commerce."[7] A firm is engaged "in commerce" within the meaning of Section 7 of the Clayton Act if it is "directly engaged in the production, distribution, or acquisition of goods or services in interstate commerce." *United States v. American Building*

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[7] 15 U.S.C. 18 (1976). The Clayton Act was amended in 1980 to extend jurisdiction to firms "affecting commerce." Antitrust Procedural Improvements Act of 1980, Pub. L. No. 96–349, Section 6(a), 94 Stat. 1154, 1157–58 (1980).

Maintenance Industries, 422 U.S. 271, 283 (1975) Participation in the flow of interstate commerce need not be substantial, it need only be more than *de minimis. Goldfarb v. Virginia State Bar,* 421 U.S. 773, 785 (1975); *United States v. M.P.M., Inc.,* 397 F.Supp. 78, 84–86 (D. Colo. 1975).

AMI has admitted doing business in a number of states. For example, at the time of the French acquisition, AMI owned or leased 44 general acute care hospitals that were located in nine states. It coordinated their activities from its Beverly Hills, California, headquarters. In the year before the acquisition, AMI acquired four domestic hospitals, a design and architectural firm, and a prepaid health care firm, all of which were located in states other than California. AMI also provided cardiopulmonary, diagnostic, and therapeutic services under contracts with hospitals in 40 states. These interstate transactions place AMI in the flow of interstate commerce. Furthermore, AMI was engaged in interstate commerce by virtue of its ownership of Sierra Vista and many other hospitals that purchase substantial amounts of goods from sources in other states, and receive substantial revenues from out-of-state sources, including payments from Medicare and private third-party payor insurance plans. *See United States v. Hospital Affiliates International, Inc.,* 1980–81 Trade Cas. (CCH) ¶ 63,721 at 77,853 (E.D. La. 1980).

At the time of the acquisition, French Hospital Corporation was making payments of over $200,000 per year on equipment leases, which payments were sent to locations outside the State [123] of California. (F. 8, n. 4) French Hospital Corporation received millions of dollars in payments that originated outside of the State of California from Medicare and private third-party payors. French Hospital Corporation made substantial purchases of supplies and equipment from out-of-state sources. Finally, French Hospital Corporation occasionally treated patients that did not reside in the State of California. The payment of funds to locations outside the State of California, the receipt of funds from interstate sources, and treatment of patients from other states placed French Hospital Corporation in the flow of interstate commerce. *Goldfarb v. Virginia State Bar,* 421 U.S. at 783–84; *McLain v. Real Estate Bd. of New Orleans,* 444 U.S. 232, 245 (1980); *United States v. Hospital Affiliates International, Inc., supra. See also Hospital Building Co. v. Trustees of Rex Hospital,* 425 U.S. 738, 744 (1976); *Crane v. Intermountain Health Care, Inc.,* 637 F.2d 715, 725 (10th Cir. 1981) (en banc).

French Medical Clinic, Inc. leased substantial medical equipment from an out-of-state concern, and made payments therefor approximating $200,000 per year. (F. 6) Most of the payments for rental of this equipment were made in interstate commerce. The CAT scanner owned by French Medical Clinic, Inc. was used both in the Clinic and for inpatients at French Hospital. (F. 167, n. 18) It is inferred that the Clinic purchased supplies and equipment in interstate commerce, and received substantial funds in interstate commerce as payment for health care services. Thus, French Medical Clinic, Inc. was substantially involved in the flow of interstate commerce at the time of the French acquisition. As the court in *McLain* explained, its earlier holding in *Goldfarb* that the activities of the attorneys were within the stream of interstate commerce "in no way restricted it to those challenged activities that have an integral relationship to an activity in interstate commerce." *McLain v. Real Estate Bd. of New Orleans,* 444 U.S. at 244.

Respondents, French Medical Clinic, Inc., and French Hospital Corporation, prior to the acquisition, could not have furnished hospital services to patients without the purchasing of supplies from interstate sources, leasing of equipment from interstate sources, and receiving substantial funds in payment for services from interstate sources. The actual furnishing of the hospital services to patients [*e.g.,* anesthesiology], which respondents seek to isolate as being a local activity (RB, pp. 151–52; Resp. Reply Brief, p. 186), is "an integral part" of the total hospital operation which is substantially involved in interstate commerce. *See Goldfarb v. Virginia State Bar,* 421 U.S. at 784–85. Thus, for jurisdictional purposes, all necessary parties to the French acquisition were "directly engaged in the production, distribution, or acquisition of goods **[124]** or services in interstate commerce." *United States v. American Building Maintenance Industries,* 422 U.S. at 283.

b. *Section 5 of the FTC Act*

Section 5 of the Federal Trade Commission Act declares unfair methods of competition "in or affecting commerce" to be unlawful. 15 U.S.C. 45 (1976). The activities which place AMI, French Hospital Corporation, and French Medical Clinic, Inc. in interstate commerce for purposes of Section 7 of the Clayton Act are also activities which meet the "in commerce" requirements of Section 5. This showing is sufficient to establish jurisdiction under Section 5.

The "affecting commerce" requirement of Section 5 is satisfied if some nexus exists between the acts or practices at issue and interstate commerce. Purely intrastate activities are deemed to "affect commerce" if the activity, local in nature, "has an effect on some other appreciable activity demonstrably in interstate commerce." *McLain v. Real Estate Bd. of New Orleans, Inc.,* 444 U.S. at 242 (1980); *see also Hospital Building Co. v. Trustees of Rex Hospital, supra.* To establish the jurisdictional element of a Section 5 violation, "it would be sufficient [for complaint counsel] to demonstrate a substantial effect on interstate commerce" generated by AMI's and French Hospital Corporation's total hospital operation; a more particularized showing is not required. *McLain v. Real Estate Bd. of New Orleans,* 444 U.S. at 242.

The record in this proceeding demonstrates that AMI's acquisition of French Hospital and AMI's attempt to monopolize "affect" interstate commerce in a variety of ways, including the following:

(1) French Hospital receives substantial interstate payments from private third-party payors. Many of these private third-party payors reimburse on the basis of charges rather than costs. The French acquisition may tend to impair price competition which will necessarily mean that interstate payments from such charge-based payors will be affected. AMI is in the process of standardizing the charges of its three hospitals in San Luis Obispo County. Any standardization of charges will affect these interstate payments. In addition, AMI will seek a return on its investment in French Hospital, which investment substantially exceeds the investment of French's previous owners. This will affect charges.

(2) French Hospital also receives payments from Medi-Cal, a portion of which is interstate in nature (*i.e.,* the federal share). AMI's acquisition of French Hospital will **[125]** substantially affect these revenues to the extent that AMI's conduct eliminates price competition for Medi-Cal business.

(3) Medicare payments, which are interstate in nature, are also affected by AMI's acquisition of French Hospital. Medicare paid AMI's San Luis Obispo County hospitals on the basis of costs, and AMI's acquisition of French Hospital affected the cost basis upon which its Medicare revenues were predicated. A substantial portion of the almost $11 million purchase price for French Hospital was amortized by AMI and passed on to Medicare each year, and also passed on to Medi-Cal in essentially the same way. Since the cost-based reimbursement formulas used by Medicare and Medi-Cal included a reasonable return on equity (profit), AMI's return on equity on this stepped-up investment basis resulted in higher reimbursement to AMI than to the previous owners of French. These changes in French Hospital's cost basis affected interstate payments to the hospital.

(4) French Hospital purchased a substantial amount of drugs, medical devices, and other supplies from sources outside of California. AMI's acquisition of French affects these interstate purchases to the extent that reduced competition among hospitals resulting from the acquisition will affect the nature and quantity of supplies that AMI purchases.

These links with interstate commerce are sufficient to satisfy the "affecting commerce" requirement of Section 5. *See Hospital Building Co. v. Trustees of Rex Hospital, supra; Indiana Federation of Dentists,* Dkt. 9118, 101 F.T.C. 57 (1983); *American Medical Ass'n.,* 94 F.T.C. 701, 993–996, *aff'd as modified,* 638 F. 2d 443 (2d Cir. 1980); *aff'd per curiam by an equally divided court,* 455 U.S. 676 (1982) Nor is it necessary to show a "direct" connection between the challenged act or practice and an effect on interstate commerce, *Hospital Building Co.,* 425 U.S. at 744–45; nor the magnitude of the effect; or even that an effect has already occurred. *McLain,* 444 U.S. at 243; *Goldfarb,* 421 U.S. at 785. This is particularly true for violations of the Clayton and Federal Trade Commission Acts, which can be based on probabilities of anticompetitive effects and not necessarily actualities. *FTC v. Motion Picture Adv. Service Co.,* 344 U.S. 392, 394–395 (1953). Further, it is not necessary to show that there will be a reduction, rather than an increase, in the flow of commerce through interstate channels. *Harold Friedman Inc. v. Thorofare Markets Inc.,* 587 F.2d 127, 132, 137 (3d Cir. 1978)

The record establishes that the Federal Trade Commission has jurisdiction over the acquisition of French Hospital both under Section 7 of the Clayton Act and Section 5 of the FTC Act. **[126]**

Finally, respondents place reliance upon *Cardio-Medical Associates v. Crozer-Chester Medical Center,* 552 F.Supp. 1170 (E.D. Pa. 1982), as establishing that the provision of health services is essentially local in nature, and that the interstate transfer of funds, the interstate purchase of drugs and supplies, and the treatment of some out-of-state patients do not satisfy "in commerce" or "affecting commerce" jurisdiction. That proceeding involved allegations of denial of certain specialized privileges in cardiology at a medical center to four local physicians. The court stressed that the plaintiffs' case related "only to a limited number of cardiology procedures. . . . " *Id.* at 1203. There was no allegation that plaintiffs had been foreclosed from practicing cardiology at the defendant medical center, or from pursuing their practices in their offices, or anywhere else. *Ibid.* The court pointed out that the interstate commerce involved, if any, was "miniscule," *Ibid.,* that "[i]f antitrust jurisdiction can be invoked on the basis of these plaintiffs' allegations, virtually all activities, even if purely local, and including our hypothetical house painter, would be subject to federal antitrust scrutiny." *Id.* at 1205.

In this present proceeding the antitrust challenge is directed to the acquisition of an entire hospital operation, not some limited aspect of patient services such as was involved in *Cardio-Medical.* Thus, even if the holding in *Cardio-Medical* is correct on its facts, it is inapplicable to this proceeding.

C. *The Relevant Markets*

Section 7 of the Clayton Act prohibits acquisitions where the effect thereof may be "substantially to lessen competition, or to tend to create a monopoly" in any "line of commerce" in any "section of the country." 15 U.S.C. 18 (1976). Therefore, determination of the relevant product market and the relevant geographic market is a necessary predicate to the examination of the legality of a merger under the Clayton Act, *United States v. Marine Bancorporation,* 418 U.S. 602, 618 (1974), because measurement of the substantiality of impact may be made only in terms of the market affected. *United States v. E.I. du Pont de Nemours & Co.,* 353 U.S. 586, 593 (1957); *Brown Shoe Co. v. United States,* 370 U.S. 294, 324 (1962). "[T]he problem of defining a market turns on discovering [127] patterns of trade which are followed in practice." *United States v. United Shoe Machinery Co.,* 110 F.Supp. 295, 303 (D. Mass. 1953), *aff'd per curiam,* 347 U.S. 521 (1954).[8]

1. The Relevant Product Market

The relevant product market alleged in the complaint for the purpose of evaluating the anticompetitive effect of AMI's acquisition of French Hospital is "general acute care hospitals." It is clear, however, that it is the patient services furnished by general acute care hospitals that is the product market intended by the complaint. (Complaint, ¶ 6)

The outer boundaries of a market are set by the "reasonable interchangeability of use" or "cross-elasticity of demand" between the product and proposed potential substitutes. *Brown Shoe,* 370 U.S. at 325. However, the relevant market cannot include the infinite range of possibilities that may in some aspects be interchangeable, and yet still retain any meaning as a concept and provide any guidance in fashioning a rule. The circle must be drawn narrowly to exclude any other product to which, within reasonable variations in price, only a limited number of buyers will turn; in technical terms, products whose cross-elasticities of demand are small.[9] (*See, Times-Picayune Publishing Co. v. United States,* 345 U.S. 594, 612, n. 31 (1953)) It is now established that within a broad product market well-defined submarkets may exist which constitute product markets for antitrust purposes. *Brown Shoe* outlines the **[128]** criteria by which such product markets are to be established. These are:

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[8] Market definition is also an element of an attempt to monopolize claim. The process of market definition in monopolization cases is similar to that used in Section 7 cases. *United States v. Grinnell Corp.,* 384 U.S. 563, 573 (1966).

[9] The Commission, in its statement concerning horizontal mergers, stated: "The purpose of product market analysis is to ascertain what grouping of products or services should be included in a single relevant market. Where the cross-elasticity of demand for separate products or services is high, they normally will be within the same product market. Similarly, a high cross-elasticity of supply tends to suggest the existence of a common product market. Therefore, the issue of whether related products or services place a significant constraint on the ability of merging firms to raise prices, limit supply or lower quality is central to evaluating the competitive effects of a horizontal merger." Statement of Federal Trade Commission Concerning Horizontal Mergers, June 14, 1982, at 12.

> [I]ndustry or public recognition of the submarket as a separate economic identity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors.

370 U.S. at 325.

In establishing these guidelines, the Court noted that absolute precision in definition of the market is not what is required; the definition of the relevant market must merely reflect the market realities. 370 U.S. at 336, 342, n. 69. In addition, it is not necessary that the market chosen fulfill *all* of the criteria. *United States v. Aluminum Co. of America,* 377 U.S. 271, 276–77 (1964); *Reynolds Metals Co. v. FTC,* 309 F.2d 223, 227 (D.C. Cir. 1962).

Courts have held in a variety of different industries that when firms offer a group of services that are, as a matter of trade reality, considered economically distinctive when viewed collectively, the "cluster" of products or services can and should be treated as a product market for purposes of antitrust analysis. *United States v. Phillipsburg National Bank & Trust Co.,* 399 U.S. 350, 360–361 (1970) (commercial banking services); *United States v. Philadelphia National Bank,* 374 U.S. 321, 356 (1963) (commercial banking services); *United States v. Grinnell Corp.,* 384 U.S. 563, 571 (1966) (central station protective services); *Crown Zellerbach Corp. v. FTC,* 296 F.2d 800, 811 (9th Cir. 1961), *cert denied,* 370 U.S. 937 (1962) (paper products); *American Medicorp v. Humana, Inc.,* 445 F. Supp. 589, 605 (E.D. Pa. 1977) (short-term acute care hospital services). This principle of a "cluster of services" provided by general acute care hospitals is the most appropriate product market for purposes of analyzing the effects of the French Hospital acquisition.[10] **[129]**

General acute care hospitals offer a cluster of services not available from any other type of health facility. General acute care hospitals in California are required to offer the following services on a 24-hour basis: medical, nursing, surgical, anesthesia, laboratory, radiology, pharmacy, and dietary services. *Cal. Health & Safety Code* Section 1250(a) (Deering 1982). There are no reasonable substitutes in consumption or supply for this cluster of services. The cluster of services offered by general acute care hospitals provides for the complete treatment of patients with a broad range of conditions. Thus, the hospital offers a variety of facilities to help diagnose disease; it offers facilities for surgery; it provides round-the-clock nursing services. Most importantly, hospitals provide the equipment and personnel to deal with unexpected, but potentially life-threatening, situations. While a particular service may be available at some other institution, general acute care hospitals are unique in that they alone offer this whole cluster of services in a single setting. (F. 35)

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[10] Complaint counsel proposes that the product market can be characterized in two ways: general acute care hospital services (hospital services) or general acute care hospital inpatient services (inpatient services). The narrower market of inpatient services is inconsistent with the "cluster of services" product market since it attempts to carve out all outpatient services rendered by general acute care hospitals. In addition, the record supports a conclusion that substantially all outpatient services rendered by general acute care hospitals simply were not *practically* available to consumers from other sources. (*See, e.g.,* F. 45–46)

It is critically important for doctors to have access to general acute care hospitals. Surgeons, for example, require hospitals not only for the surgery itself, but also for the other support staff and services necessary to care for the patient before and after the surgery. Only hospitals have the necessary equipment to perform major surgery. Likewise, hospitals are often the only facilities able to perform certain sophisticated tests which doctors require.

A number of physical ailments can be treated safely only by admitting a patient to the hospital. These situations include, among others, patients in need of certain kinds of surgery, patients requiring certain diagnostic procedures, and patients in need of observation or around-the-clock monitoring. Almost any patient with acute cardiovascular disease must be admitted to the hospital for treatment. Patients in need of intravenous medication, and those in need of intensive care services, must be admitted to the hospital. Also, patients having procedures which require general anesthesia usually will be admitted to the hospital. **[130]**

There are some other situations where it is possible to treat a patient without admission to a hospital, but a number of factors make this option unattractive. In those instances where nursing care is required, a patient could be treated at home only if private duty nurses were employed at great expense. Even if nurses were hired, it still might be necessary to admit a patient if complications arose. (Boyd, 335) Unexpected complications, or patients with certain "predisposing conditions" creating the risk of complications, makes treating many conditions in a nonhospital setting extremely risky.

Some ancillary services, such as x-rays and laboratory tests, which are rendered to inpatients also are available in doctors' offices and clinics and private labs. However, these nonhospital facilities are not used to treat individuals in need of inpatient care. When people needing inpatient care require such services, they use the facilities present in the hospital.

The most important outpatient service provided by a hospital is the hospital's emergency room. All hospitals in San Luis Obispo County offered full-time emergency room services. In some case, emergency rooms may treat relatively minor problems that probably could be treated in a doctor's office or a clinic. But patients often come to emergency rooms unaware of what is wrong with them, but aware that the full gamut of care is available to them at an emergency room. Doctors' offices, which are not open 24 hours a day and cannot provide as broad a range of services as emergency rooms, are therefore not a substitute for a patient who believes he needs emergency care. A patient seeking emergency care may use the emergency room because he does not have a regular doctor or is not readily knowledgeable about an available doctor.

The cluster of services offered by general acute care hospitals is distinct from that available from other sources in at least two ways. First, hospitals offer a collection of complementary services that are most efficiently supplied together. These services are needed by patients and doctors alike; indeed, the services are essential to seriously ill patients needing sophisticated back-up services, and patients whose general health status or medical condition poses a risk of complications. Second, the cluster of hospital services are not available outside the hospital. Patients needing full-time nursing care or observation, emergency support services, many kinds of surgery, intensive care, or certain sophisticated equipment, have no reasonable alternative to hospital care. Other types of health care facilities and services, such as doctors' offices, outpatient laboratories, long-term care [131] facilities and home health services, simply are not reasonably interchangeable with hospital services, for they do not and cannot offer the range and combination of services found in hospitals.

Moreover, cross-elasticity of supply for hospital services is also low. Legal requirements and other considerations indicate that other firms cannot easily begin to offer hospital services if existing hospitals raise prices, restrict output, or lower quality. While AMI asserts that nationwide, more medical and surgical procedures are being performed in doctors' offices or in freestanding surgical centers and more diagnostic tests are being performed on an outpatient basis, the evidence adduced at trial showed that these factors are not likely to have any significant effect on San Luis Obispo County hospitals in the foreseeable future.

In addition to the lack of reasonable substitutes for hospital services, other factors reinforce the conclusion that general acute care hospital services constitute a distinct product market. General acute care hospitals are recognized by government agencies and industry participants as a distinct class of health care provider. There is a well-accepted definition of acute care hospitals used by groups such as health planning organizations, hospital associations, accrediting bodies, and government agencies that does not include long-term care facilities, psychiatric hospitals, or doctors' offices or clinics. In addition, California law treats general acute care hospitals separately from other types of facilities that offer inpatient care, such as psychiatric and specialty hospitals and skilled nursing and intermediate care facilities. *Cal. Health & Safety Code* Section 1250 (Deering 1982). AMI documents introduced into evidence listed only other general acute care hospitals as competitors of its hospitals in San Luis Obispo County. Hospital administrators, when asked about their competitors, mentioned only other general acute care hospitals and not outpatient facilities.

In sum, general acute care hospital services are clusters of services for which patients have no reasonable substitutes outside hospitals. Nor do other facilities exist that could be expected to offer interchangeable services if existing hospitals exercise market power to the detriment of consumers. Thus, there are no alternatives that can significantly constrain pricing and other behavior of general acute care hospitals. As a consequence, general acute care hospital services is the appropriate product market in which to evaluate the competitive effects of AMI's acquisition of French Hospital. **[132]**

2. The Relevant Geographic Markets

a. *Legal Criteria*

The complaint alleges that the relevant geographic market is San Luis Obispo County and/or parts thereof. (Complaint, ¶ 7) Complaint counsel asserts that the city of San Luis Obispo is a relevant geographic market, in addition to San Luis Obispo County. More than one relevant market may exist in an antitrust case. *United States v. Marine Bancorporation,* 418 U.S. 602, 621 (1974); *United States v. Pabst Brewing Co.,* 384 U.S. 546, 551–552 (1966).

The purpose of defining a geographic market[11] is to delineate the geographic area within which market power could be successfully exercised. Thus, the relevant geographic market is the territory within which a firm could exercise market power because sellers outside this area lack the ability to compete on substantial parity with those in the market.[12]

In determining the relevant geographic market, the courts seek to identify the market area where the effect of the merger will be direct and immediate. The "area of effective competition in the known line of commerce" is determined by delineating "the market area in which the seller operates, and to which the purchaser can practicably turn for supplies." *United States v. Philadelphia National Bank,* 374 U.S. 321, 359 (1963) (quoting *Tampa Elec. Co. v. Nashville Coal Co.,* 365 U.S. 320, 327 (1961)).

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[11] The terms "section of the county," as used in Section 7 of the Clayton Act, and "relevant geographic market" are equivalent. *United States v. Marine Bancorporation,* 418 U.S. 602, 620–21 (1974).

[12] As the Commission has noted in discussing geographic market definition, "[t]he issue is whether producers of the merged firm's product in other geographic areas place a significant constraint on the ability of the merged firm to raise price or restrict output. As a general proposition, an area is a separate geographic market if a change in the price of the product in the area does not, within a relevant period of time, induce substantial changes in the quantity of the product sold in other areas."

One commentator has defined the relevant market as follows:

> The area of effective competition may be any commercially significant geographic area which can [133] reasonably be said to confine the relevant commercial activities. If sellers within the area are making price and output decisions protected from the need to take account of sellers outside the area, there is a distinct market. If sellers within the market must take account of sellers outside it, either because these sellers are mobile and can easily come into the area to sell, or because buyers are mobile and can easily go outside of the area to buy, the market is being defined too narrowly.

L. Sullivan, *Handbook of the Law of Antitrust* 68 (1977).

The exact size of the market need not be established. *British Oxygen Co. Ltd.,* 86 F.T.C. 1241, 1371 (1975), *rev'd sub nom. on other grounds, BOC International Limited v. FTC,* 557 F.2d 24 (2d Cir. 1977); *Papercraft Corp.,* 78 F.T.C. 1352, 1405–06 (1971), *aff'd,* 472 F.2d 927 (7th Cir. 1973). "[P]recision of detail is less important than the accuracy of the broad picture presented." *Brown Shoe Co. v. United States,* 370 U.S. 294, 342, n. 69 (1962). The geographic market, like the product market, must correspond to commercial realities and be economically significant. *Id.* at 336–37. The physical dimensions of the geographic market need not be set out in metes and bounds, *Pabst Brewing Co.,* 384 U.S. at 549, but must constitute a rough approximation of the relevant market. In *Philadelphia National Bank,* the Supreme Court stated that the relevant geographic markets in service industries are generally local, because "convenience of location is essential to effective competition." 374 U.S. at 358.

In defining the geographic market for hospital services, the Commission and the Justice Department have stated that the factfinder should use "the 'traditional' method of economic analysis" to identify "the area of effective competition that the [hospital] encounters when it offers the designated product for sale." Brief for United States as Amicus Curiae at 13–14, *Jefferson Parish Hospital District No. 2 v. Hyde, cert. granted,* 51 U.S.L.W. 3649 (U.S. Mar. 7, 1983) (No. 82–1031).[13] In a case involving hospital services, patient flow [134] statistics are comparable to shipment patterns and can be used as an indicator of the boundaries of the geographic market.

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[13] Courts have found local geographic markets of varying sizes in antitrust cases involving hospitals, depending on the particular product market at issue and the economic factors affecting the local area. *See, e.g., Robinson v. Magovern,* 521 F.Supp. 842, 885–86 (W.D. Pa. 1981), *aff'd mem.,* 688 F.2d 824 (3d Cir. 1982), *cert. denied,* 103 S.Ct. 302 (1982) (market for adult open heart surgery was 16-county area surrounding Pittsburgh, Pennsylvania); *United States v. Hospital Affiliates International, Inc.,* 1980–81 Trade Cas. (CCH) ¶ 63,721 at 77,853 (E.D. La. 1980) (market for inpatient psychiatric care was New Orleans and surrounding area constituting the local health systems area ("HSA")); *American Medicorp v. Humana, Inc.,* 445 F.Supp. 589, 604, 605 (E.D. Pa. 1977) (market for development of new hospitals was the HSA; market for delivery of short term acute care community hospital services was town of Bluefield, West Virginia).

b. *San Luis Obispo County*

The patient flow statistics have two aspects: first, they show that hospitals in San Luis Obispo County draw almost all of their patients from the county, and second, they show that the vast majority of county residents are served by hospitals located within the county. Taken together, these two aspects of patient flow, "inflow" and "outmigration," are strong indicators that the county is the broadest area constituting a relevant market in this case.

The inflow statistic was determined from 1980 patient origin data from the five hospitals in the county (French, Sierra Vista, SLO General, Twin Cities and Arroyo Grande). These data show that over 90 percent of persons hospitalized at these hospitals were residents of the county (*i.e.,* there is very little inflow). Studies conducted by AMI corroborate this finding.

While outmigration cannot be ascertained with the same degree of precision as the inflow statistic, the evidence is clear that the degree of outmigration from the county is small and that most county residents do not leave the county to obtain hospital services. For example, official government statistics show that only 14.5 percent of Medicare beneficiaries aged 65 and over who were residents of San Luis Obispo County and were hospitalized in 1977, were hospitalized outside the county. Similarly, only 13 percent of county residents receiving Medi-[135]Cal benefits who were hospitalized in 1977 were discharged from hospitals outside the county.

AMI has attempted to show that outmigration was much higher than these government statistics indicate. One of AMI's witnesses, Robert E. Mittelstaedt, Jr., a Vice President of AMI's subsidiary, Friesen International, Inc., prepared for trial and testified concerning a chart estimating that 30 percent of the county residents who were hospitalized were hospitalized outside the county. This estimate is inconsistent with other, more reliable, evidence in the record concerning outmigration, including not only the official government data cited above, but also an earlier study prepared by Mr. Mittelstaedt. Mr. Mittelstaedt's estimate prepared for this litigation is based on assumptions whose validity is subject to serious question. In particular, Mr. Mittelstaedt calculated his outmigration estimate based on an assumption that residents of the county utilize hospitals at the same rate as residents of California in general. In fact, record evidence shows that persons residing in the health systems area ("HSA") that encompasses San Luis Obispo County utilize hospitals at a substantially lower rate than do Californians on average. When Mr.

Mittelstaedt's estimate is recalculated using the local HSA utilization rate instead of the much higher California rate, the result is an estimate that is consistent with the Medicare and Medi-Cal data in the record.

Thus, while precise data on outmigration is unavailable, the record evidence is sufficient to show that at most it is approximately 14 percent. Since Mid-Coast Health Systems Agency, the planning body for the area in which San Luis Obispo county is located, estimates that outmigration from the designated health systems area amounts to only five percent of inpatient days, outmigration from the county could well be lower than 14 percent. French and Sierra Vista are high-quality hospitals that offer a broad range of services, and there are three other hospitals in the county. These facts suggest that it is unlikely that outmigration would be much higher in San Luis Obispo County than in the HSA as a whole. Outmigration may therefore be as little as five percent.

These outmigration percentages actually overstate the extent to which hospitals in San Luis Obispo County face effective competition from hospitals outside the county. For example, some residents hospitalized outside the county presumably became ill while traveling. More importantly, some county residents must travel to hospitals in other areas in order to receive specialized, sophisticated services that are not available in San Luis Obispo County. (*See, e.g.*, F. 70) Other than these two basic reasons for outmigration, there is little **[136]** indication of competition between county hospitals and hospitals outside the county.

It is not surprising that there is little "inflow" and "outmigration" of patients. First, for reasons of convenience and limited mobility, patients prefer to go to a hospital near home where their family and friends can visit them. Second, the location of the admitting physician is a major factor in determining where patients are admitted. Both complaint counsel's and AMI's physician witnesses stated that it is impractical for a physician to make daily rounds at hospitals distant from the physician's office. The record is clear that virtually all admissions (99.7% in 1980) to San Luis Obispo County hospitals were made by physicians whose offices are located in the county. (F. 65) These physicians actively practice only in San Luis Obispo County and there is no evidence whatsoever that these physicians will rapidly shift their office locations to another site in response to fluctuations in the price and quality of hospital services. This makes it likely that patients will continue to be hospitalized in the county. While residents of the county could theoretically shift to other hospitals by seeking out physicians located outside the county, doctor-patient relationships are often highly personal, and based on habit, custom, and convenience, making rapid shifts to hospitals outside the county unlikely.

Industry participants view San Luis Obispo County as a relevant geographic market. Officials of AMI in planning documents look upon the county as a separate market and point to only county hospitals as competitors. Hospital administrators also look upon county hospitals as their only competition. Efforts to attract patients are not directed outside the county because it is believed there is little hope of getting patients from those areas. Specialists who received patients through referral stated that most doctors that refer patients to them are located in San Luis Obispo County. Furthermore, it is very rare for doctors in the county to refer patients to doctors outside the county. When it was done, it is usually patients with unusual medical problems who are referred to major medical centers in the Los Angeles or San Francisco areas, and at Stanford University.

AMI contends that northern Santa Barbara County should be included in the relevant geographic market based largely on the fact that the two hospitals in the town of Santa Maria (Valley Community Hospital and Marian Medical Center), located in northern Santa Barbara County, draw approximately 9 and 11 percent of their patients, respectively, from San Luis Obispo County. **[137]**

Analysis of the patient origin data by ZIP code shows that most of the county residents who use Santa Barbara hospitals live in Nipomo, a town close to the county border that accounts for only 3.4 percent of the population of the County of San Luis Obispo. Bureau of the Census, U.S. Dept. of Commerce, *1980 Census of Population, General Population Characteristics - California* 6–31, 6–34, 6–36, 6–40. As the Supreme Court has recognized, some crossover along the fringe of a relevant geographic market is inevitable. "To be sure, there is still some artificiality in deeming the four-county area the relevant 'section of the country' so far as businessmen located near the perimeter are concerned. But such fuzziness would seem inherent in any attempt to delineate the relevant geographical market." *United States v. Philadelphia National Bank*, 374 U.S. 321, 360 n. 37 (1963). The small crossover here does not negate the basic soundness of San Luis Obispo County as the relevant geographic market.

The Supreme Court has stressed that the relevant market area is the area in which the designated product is "marketed to a significant degree by the acquired firm." *United States v. Marine Bancorporation*, 418 U.S. 602, 621 (1974). The evidence shows that the hospitals in San Luis Obispo County draw very few patients from northern Santa Barbara County. None of the San Luis Obispo County hospitals drew more than 4 percent of its patients from northern Santa Barbara County. Examination of physician admitting patterns confirms this conclusion. With rare exception, physicians whose offices are located in northern Santa Barbara County do not admit patients to hospitals in San Luis Obispo County. Similarly, physicians who practice in San Luis Obispo County almost never admit patients to hospitals outside the county.

c. *The City of San Luis Obispo*

When assessing the competitive effects of a merger, it is necessary to focus on the area where "the effect of the merger on competition will be direct and immediate." *United States v. Philadelphia National Bank,* 374 U.S. 321, 357 (1963). The evidence shows that AMI's acquisition of French Hospital has its most direct effect on competition in the city of San Luis Obispo. Thus, whether described as a "market" or a "submarket," the city and its immediate environs are also an appropriate geographic area to use in determining the legality of the French acquisition.

Examination of the patient flow statistics indicates that residents of the city and environs go almost exclusively to hospitals located in the city. Residents of the city of San **[138]** Luis Obispo and the surrounding area[14] accounted for less than one percent of the 1980 admissions at Twin Cities Hospital, and less than two percent of Arroyo Grande's admissions. (F. 80) The statistics show that the three hospitals in the city do draw a substantial number of patients from other sections of the county. 1980 patient origin data indicate that these patients accounted for approximately 41 percent of the admissions at Sierra Vista, 44 percent at French, and 51 percent at SLO General. (F. 79)

The fact that patients come to hospitals in the city is not surprising since French and Sierra Vista are larger hospitals and better equipped than the hospitals in the north county area and the south county area. Twin Cities and Arroyo Grande hospitals do not offer services such as CAT scan, cardiac catheterization, and open heart surgery. Arroyo Grande does not have an obstetrics department. SLO General is the hospital of choice for obstetrics and has a renal dialysis unit. Thus, patients from the outlying areas come to the city for services not available locally.

One of the most significant "commercial realities" affecting competition in the market for inpatient hospital services is the role that doctors play in competition among hospitals. Since doctors are responsible for admitting patients to hospitals, hospitals necessarily compete for physicians in order to capture their admissions. The effective are of competition for these physicians is limited, however, because doctors, for reasons of practical necessity, admit patients to hospitals located near their offices. Physician witnesses with offices in the city of San Luis Obispo confirmed that they do not admit patients to hospitals outside the city, because commuting times make it highly impractical, and because if patients were at distant hospitals they would be unable to provide proper medical supervision. (F. 77)

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[14] The environs of San Luis Obispo City include the towns of Los Osos, Morro Bay, and Baywood Park.

Statistics on physician admitting patterns confirm that the location of a physician's office is a substantial factor in determining where patients are admitted. Approximately 98 percent of all admissions to the three hospitals in the city of San Luis Obispo were by physicians whose offices are located in the city and its environs. (F. 75) Similarly, 99 percent of admissions to Twin Cities were by physicians with offices in the North County cities of Templeton, Atascadero, and Paso Robles. **[139]** (F. 76) The South County hospital, Arroyo Grande, drew over 92 percent of its admissions from doctors located in that area of the county. (F. 76)

Thus, while city hospitals draw a significant number of their patients from the North and South County areas, virtually all of the admissions of these patients are made by physicians located within the designated submarket, the city and its environs, because Twin Cities and Arroyo Grande were too far away and because they offered no services that were not available in the city. Twin Cities and Arroyo Grande Hospitals are served by two separate medical staffs, and these hospitals do not make any effort to attract patients from the city area.

The Supreme Court has stressed that practical "commercial realities" govern when defining relevant geographic markets. *See, e.g., Brown Shoe Co. v. United States,* 370 U.S. 294, 336 (1962); *United States v. Phillipsburg National Bank & Trust Co.,* 399 U.S. 350, 362 (1970). The commercial realities of the hospital services market in which French and Sierra Vista operate are reflected in a variety of evidence demonstrating that those involved in the hospital services market view the city and its environs as a distinct geographic market. For example, on numerous occasions prior to this litigation, AMI officials observed that county hospitals outside the city provide little competition to the hospitals in the city. A relevant illustration is a 1978 AMI planning study of Arroyo Grande which stressed the relative lack of competition between this hospital and the three hospitals located in the city of San Luis Obispo:

> It is important to reiterate that our findings clearly pointed to the fact that there is no definable competition for Arroyo Grande Community Hospital. The hospitals south of Arroyo Grande are geographically located too far away to be competition and the facilities, Sierra Vista and French and County [SLO General] in the north likewise are geographically too far away to be considered direct competition.

(CX 197N) **[140]**

In addition, testimony by hospital administrators and physicians supports defining the city and environs as a separate submarket. For example, the former administrator of French testified that he regarded Sierra Vista and, to a lesser extent, SLO General as his competition for patients and physicians. Neither Twin Cities nor Arroyo Grande were viewed as competitors because of their location and because they offered no services not available in the city.

French, Sierra Vista and SLO General are in direct competition for patients located in the city and its environs. They also compete for patients in the outlying county areas who need services only available in the city, or who come to see physicians located in the city. These patients cannot "practicably turn" to hospitals outside the city, unless their physician's office location changes or they select a new physician whose office is located outside the city. Doctors obviously cannot promptly change their office locations to another city in response to moderate changes in price or quality levels at the city hospitals. Physician-patient relationships, while perhaps more practicably adjusted in most cases than the city of a doctor's office, are also unlikely to be rapidly altered, since personal preferences, habit, and trust often play a significant role in an individual's choice of a physician. Furthermore, patients may not always be aware of reductions in certain categories of service most noticeable to physicians. These factors serve to insulate hospitals within the city from competition by Twin Cities and Arroyo Grande and strongly indicate that the city and its environs constitute a separate geographic market.

D. *Competition In The Hospital Market*

1. Hospital Competition Nationally

In 1981, health care expenditures in this country were $286.6 billion, or 9.76 percent of the gross national product. *U.S. Department of Commerce, Statistical Abstract of the United States,* 102, 418 (1982–1983). The largest component of this expense was hospital care; $118 billion in 1981, up from $9.1 billion in 1960. *Ibid.*

Congress recognized in 1974 that the health care industry does not respond to classic marketplace forces:

> [T]he health care industry does not respond to classic marketplace forces. The highly technical [141] nature of medical services together with the growth of third party reimbursement mechanisms act to attenuate the usual forces influencing the behavior of consumers with respect to personal health services. For the most part, the doctor makes purchasing decisions on behalf of the patient and services are frequently reimbursed under health insurance programs, thus reducing the patient's immediate incentive to contain expenditures.

S. Rep. No. 1285, 93d Cong., 2d Sess. 39 (1974), *reprinted in* 1974 U.S. Code Cong. & Ad News 7842 at 7878.

In connection with hospital services, the 1974 Senate Report stated:

> Investment in costly health care resources, such as hospital beds, coronary care units or radioisotope treatment centers is frequently made without regard to the existence of similar facilities or equipment already operating in an area. Investment in costly facilities and equipment not only results in capital accumulation, but establishes an ongoing demand for payment to support those services. There is convincing evidence from many sources that overbuilding of facilities has occurred in many areas, and that maldistribution of high cost services exists.

(*Ibid.*)

In 1979 Congress amended the 1974 National Health Planning and Resources and Development Act in part as follows:

> The Congress finds that the effect of competition on decisions of providers respecting the supply of health services and facilities is diminished. The primary source of the lessening of such effect is the prevailing methods of paying for health services by public and private health insurers, particularly for inpatient health services and other institutional health services. As a result, there is duplication and excess supply of certain health services and facilities, particularly in the case of inpatient health services.

42 U.S.C. 300k-2(b)(1) (Supp. IV 1980) **[142]**

Price plays a less significant role as a competitive variable in the hospital market than in most other industries. Most transactions for hospital services are covered by third-party financing arrangements. The largest third-party payor is the federal government's Medicare and Medicaid programs. State governments, via their share of the Medicaid program, are also significant purchasers of hospital care. Through the traditional system of city and county hospitals, local governments also function as third-party payors. About 55% of hospital charges are paid by governmental bodies. (Derzon, 1978) The next largest third-party payors are nongovernmental insurance organizations. The largest of these is Blue Cross. Following Blue Cross in terms of magnitude of hospital services purchased are commercial insurance carriers. The least significant purchasers of hospital care are individual consumers without insurance, called "self-pay" patients. The best available evidence indicates that approximately 90 percent of all hospital charges are borne by third-party payors. (F. 95)

The effect of third-party payment is to render patients somewhat insensitive to the prices charged for hospital services. While consumers predictably do from time to time express an interest in hospital charges, the evidence is clear that patients seldom choose among hospitals based on their prices. Under the third-party payor arrangements, neither the patient nor the physician is under financial pressure with respect to hospital charges.

Another significant feature affecting competition in the hospital market is that the largest third-party payors—Medicare, Medicaid and Blue Cross—do not pay on the basis of hospital charges; rather, these payors reimburse hospitals on the basis of costs. Thus, a cost-reimbursed hospital increases its revenue by spending more; the result of incurring fewer costs is revenue reduction.

Because most patients come into contact with the system so infrequently and because of the rapid technological advances in this field, the consumer lacks information about his own need for medical care, and about the appropriateness of the care he receives. Thus, it is the doctor who makes the basic decisions about the course of care. Both patients and doctors do not have complete knowledge about the prices of the care which is sought. Partly this is because the pricing of hospital services involves thousands of individual items. More importantly, consumers and doctors lack an incentive to become aware of exact prices because they know that third-party payors will pay the vast majority of the bill. Thus, doctors do not "price shop" for their patients. **[143]**

Although the hospital industry has some unusual competitive characteristics, both price and nonprice competition among hospitals clearly exist, and price competition in particular is growing. Competition has been sharply stimulated by the recession, the general state of excess capacity that prevails in the hospital industry, and the increasing sensitivity of purchasers of hospital care to high hospital charges, particularly governmental and group purchasers.

Hospitals compete in a variety of ways to fill their beds and increase their revenues. First, hospitals compete indirectly for patients through their physicians, who often act as fiduciary agents for patients in the selection of a hospital. Hospitals seek to encourage physicians to admit patients to their hospital by offering the equipment, facilities, services, amenities, and support staff that physicians want for themselves and for their patients. A hospital risks losing physician admissions to competing hospitals if it does not respond in some way when more advanced technology, services, or amenities are offered by other hospitals. The existence of viable hospital alternatives gives physicians leverage when they seek improvements in hospital services. Aside from aiding in the assurance of quality service across-the-board, competition for medical staff physicians gives hospitals added incentive to carve out areas of special expertise, niches in the market where they can excel. There is considerable room for service competition to work over and above the floor set by regulatory bodies.

Second, hospitals compete directly for patients on a nonprice and price basis. They compete on a nonprice basis for patients by providing high quality services, amenities, and innovative care options and by educating potential patients through advertising and public relations activities. Since many hospitalizations involve elective surgery or other nonemergency treatment or tests which allow for scheduling in advance, patients consider and act upon the reputation and service choices of hospitals in deciding where to be hospitalized. A survey conducted by AMI's subsidiary, Friesen, in Tampa, Florida, for example, indicated that 35 percent of the persons surveyed would ask to go to the hospital which they preferred and another 54 percent would ask their doctor to admit them to a specific hospital, but would go where their doctor preferred. (CX 1055F) Doctors with privileges at more than one hospital usually try to honor patient preferences.

Direct price competition for patients is most commonly reflected in such visible hospital charges as room and board. Other visible items on which hospitals compete on price include emergency room charges and obstetrics. Although consumers do [144] not generally know the detailed hospital charges for various ancillary services, they learn the range of the more visible charges from the local media and from their personal experiences and those of their family and friends. AMI's own studies show it will lose patients if these visible charges are too much higher than the competition's. Hospital administrators, therefore, check the visible charges of nearby hospitals to make sure their hospitals are not out of line for fear of loss of patients if their hospital gets a reputation for exorbitant prices.

Current economic conditions are causing consumers to become increasingly more price conscious about their medical care. Long-term unemployed persons are losing the health insurance coverage offered by their former employers. Financially pressed patients are postponing elective surgery. Because of escalating hospital costs, insurance companies are raising their deductible and co-payment levels[15] and broadening exemptions to their policies, and similar proposals are being considered for federal and state programs. Insured patients often have to pay substantial amounts of their hospital bill out of their own pockets, for example, 20 percent under typical commercial health insurance plans. Where even a relatively small proportion of consumers are sensitive to price differences among hospitals, their presence helps constrain hospital pricing for all patients.

Third, hospitals compete for the volume business of group purchasers by offering competitive rates and discounts to health maintenance organizations ("HMOs"), self-funded employer plans, private insurance companies, and government programs. California is in the forefront of this competitive activity. There, the state's Medi-Cal program is actively engaging in competitive price negotiations with hospitals for the business of Medi-Cal patients. (F. 117–122) The State of California expects to achieve savings of $200 million a year under this new program. The California Blue Cross Plan has announced that it will sponsor a preferred provider program under which subscribers will receive financial incentives to obtain treatment at those hospitals which give a substantial discount. Other insurers and employee benefit plans are also setting up preferred provider plans, placing increased reliance on price competition among hospitals. Group purchasers have greater **[145]** leverage in playing off one hospital against another for a discount in areas where hospitals are experiencing excess capacity. In California, hospitals on average are operating at only 64 percent of licensed capacity.

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[15] A deductible is a sum which the patient must pay before the third-party payor will begin to pay for medical care. A co-payment is an arrangement under which the insured must pay a certain percentage of the bill for his medical services.

Fourth, hospitals also compete with each other for certificates-of-need ("CONS"). Since CONs often confer exclusive or nearly exclusive rights to offer particular services, hospitals try to gain competitive advantages over other hospitals in filing for CON applications.

To sum up, competition can and does play a valuable role in the hospital industry. It fosters innovation and high quality service; it ensures that adequate service and technology alternatives will be available to patients and physicians; it places some constraint on charges to individual patients; and it helps private and public third-party payors to restrain price increases and sometimes to secure discounts.

The record contains specific examples of both price and nonprice competition. Mr. Robert A. Derzon, one of respondents' expert witnesses, was co-director of a project conducted by the consulting firm of Lewin & Associates to compare the economic performance of investor-owned and not-for-profit hospitals. The project produced a study entitled "Two Case Studies of Competition Between Hospitals," published in 1981. (CX 1030; *see* F. 100) The Lewin Report is based on case studies of two different communities, each of which was initially served by a single non-profit hospital, but which became two-hospital towns with the entry of a new hospital operated by an investor-owned group. The Lewin Report reported how one hospital sought to forestall creation of a competing hospital by dissident physicians on its medical staff by beginning planning for an intensive care unit. The dissident physicians proceeded to open a new hospital because, in the words of one dissident, the board and administrator of the existing hospital "were not thinking about modern medicine," and provided "second-rate" medical care. When the new hospital was established, the existing hospital made service additions of the sort desired by specialists.

The Lewin Report also detailed another situation where the new for-profit hospital provided physicians with spacious, quiet, and well-lit physician dictation and chart review areas, which contrasted with a general lack of quiet space for physicians at its non-profit competitor. The new hospital also assigned blocks of operating room time to its most active surgeons, so that the surgeons could minimize preparation time and work with nurses familiar with their procedures. This policy was responsive to the complaints of surgeons about the **[146]** "first come, first served" rule for scheduling operations at the existing non-profit competitor. The Lewin Report discussed hospitals' use of loans, subsidized office space, and income guarantees for physicians as competitive strategies. The Lewin Report discussed "conscious price competition" between the two hospitals in "Lee County," as evidenced by the new for-profit hospital's policy of holding its room and board charges below those of the established non-profit hospital, and of keeping the differences between the two hospitals' ancillary charges per patient day unusually low. The Lewin Report discussed the strategy of the for-profit hospital to promote usage of its new emergency room by announcing publicly that its emergency room rates would "compare favorably" with its competitor's rates. (F. 110)

There is record evidence concerning AMI's application for a certificate-of-need to build a new hospital in Yuma, Arizona, where there was already an existing hospital. In connection with the hearing process on the application, which was opposed by the existing hospital, AMI made statements indicating that competition between hospitals would occur and would be helpful. AMI argued that:

> [A] review of YRMC's [Yuma Regional Medical Center] rate increases indicates that YRMC has difficulty in managing hospital cost without a second hospital in Yuma. Perhaps, a second hospital in Yuma will make YRMC more conscious of the need to contain hospital costs.

(CX 1051M) Mr. Victor Kolodziej, AMI Vice President and Financial Director for AMI's Pacific Southwest Region, argued that price competition would occur in Yuma if AMI were permitted to build a new hospital there to compete with the established hospital:

> What we are talking about is a deescalation in the build up of rates in the future; that what should happen within the competitive mold is that rates will not increase as they have in the past. It's not the reduction of rates themselves; it's a deescalation in the inflation of rates.
>
> They will not cut rates. We would not cut rates, but rates would not increase as rapidly in the future.

(CX 1072W)

Mr. Ronald Porter, Group Vice President of AMI and Regional [147] Director for AMI's Pacific Southwest Region also emphasized that price competition would exist if AMI were permitted to build a new hospital in Yuma:

> We believe that if efficiency is introduced into the marketplace, into our facility, it will allow us the opportunity to have rates which are lower or at the top end to be that of Yuma Regional Medical Center and that we believe that competition in this case will force both facilities to be very mindful. I think it will force both facilities to become efficient.

(CX1072V) Mr. Porter also expressed succinct evaluation of the benefits of competition: "Competition is good. Competition is healthy for the Yuma community." (CX 1072T) Mr. Kenneth Ono, an Operations Assistant with AMI's Pacific Southwest Region, and a former administrator of a hospital in Hawaii, in connection with AMI's Yuma application, described how physicians in Hawaii felt about competition between hospitals:

> [T]here were two hospitals there, and one of the comments physicians used to make was, "oh, it's really a hassle going back and forth". . . . [O]n the other hand, they said, "we like it when there's competition" because . . . they can indicate to the administrator about the progressive new things that are being done in one hospital and why can't they be done in another. . . .

(CX1072M)

There is other record evidence that AMI hospitals have engaged in various forms of price and nonprice competition. An example of competition for physicians is the "Selective Centers of Excellence Strategy" proposed by AMI subsidiary Friesen, and adopted by AMI management, for AMI's Brookwood Medical Center. This plan called for the development of OB/GYN, oncology, cardiovascular surgery, and private psychiatry—specialties in which Brookwood already provided high-quality services—into "premier" services. (CX 1060I) Friesen anticipated that the "premier" OB/GYN service would attract physicians dissatisfied with Brookwood's major competitors.

Friesen discussed competitive pricing by hospitals in the strategic plans it prepared for AMI's Community Hospital of Santa Cruz, in Santa Cruz, California, and AMI's Circle City Hospital, in Corona, California. In the Santa Cruz situation, Friesen noted that AMI's hospital lost money on room and board, and earned subnormal profits on ancillary services. Friesen [148] attributed AMI's inability to set rates sufficient to cover its costs and achieve its profit objectives to "the two hospitals competitive situation in Santa Cruz which does not permit Community [Hospital of Santa Cruz] to adjust rates as easily as other region hospitals." In the Circle City strategic plan, Friesen examined the rates of Circle City in comparison to those of other local hospitals and other AMI Western Region hospitals. One conclusion Friesen drew from that data is that "Circle City is approaching the 'rate ceiling' at which its growth in market share could be impeded by overly aggressive rate increases," which would cause patients to use competing hospitals. (*See* F. 111)

Friesen's strategic plan for AMI's Palm Beach Gardens (Florida) Community Hospital noted that Pratt and Whitney, a large area employer that is self-insured for health benefits, was asking its employees' physicians not to admit them to the hospital, in part because Pratt and Whitney's medical director believed the hospital's rates were excessive. Friesen recommended that the hospital seek to repair its relationship with Pratt and Whitney, and, upon the company's request, consider giving it a discount in return for a higher volume of patients. (*See* F. 116) Another Friesen study suggested that AMI's El Cajon (California) Valley Hospital pursue a strategy of developing similar relationships with local employers. (CX 1057B)

Since planning authorities may limit the number of certificates-of-need to be awarded for any particular program or for expansions of bed capacity, hospitals compete to identify the kinds of facilities and services their communities need, and to apply for and obtain certificates-of-need to build and operate those facilities and services. In its strategic plan for AMI's Community Hospital of Santa Cruz, Friesen urged AMI to oppose the application of Dominican Hospital, Community's sole competitor for a certificate-of-need for additional beds. Friesen warned that "[i]t is necessary to show that [AMI is] directly addressing community needs, not simply objecting to Dominican's analysis," and suggested that AMI might do so by offering new or expanded services. (CX 1054B)

At least three AMI hospitals in California engaged in price discounting for the business of HMOs. The "Health Net" HMO received discounts of between 10 and 15 percent of charges from those three hospitals, and another HMO received a discount ranging from 26 to 28 percent (depending upon volume of HMO patient days) from one of the hospitals. (*See* F. 114) Friesen's strategic plan for AMI's El Cajon (California) Valley Hospital recommended that the hospital seek the business of HMOs that do not have their own hospitals. (CX 1057B) **[149]**

2. Hospital Competition in San Luis Obispo County

Prior to AMI's acquisition of French Hospital, San Luis Obispo County presented a situation in which many of the types of competition previously described could and did exist. The county was well-supplied with physicians who could practice at any one of the five hospitals in the county. In addition, there was substantial excess hospital capacity throughout the period preceding the acquisition. In 1978, for example, the average occupancy rate for all five hospitals in the county was only 54.2 percent. Furthermore, the hospitals had particular strengths and weaknesses, so patients and physicians were presented with a number of choices among the hospitals.

The city of San Luis Obispo contained the largest hospitals in the county, Sierra Vista with 172 acute care beds, and French with 138 acute care beds. Both hospitals offered a wide range of services. Sierra Vista, which was considered one of AMI's finest hospitals (CX 307), had an active emergency room and offered CAT scanning, nuclear medicine and ultrasound. French also offered a number of specialized services, including CAT scanning, cardiac catheterization, and pediatrics. In addition, it was recognized for the quality of its nursing staff and the quality of food served to patients. SLO General, which was heavily subsidized by the county, was the choice of people without health insurance and those who relied on the county to pay for their health care. It was not as modern as French and Sierra Vista and was considered by many doctors as inferior to French and Sierra Vista. SLO General is the hospital of choice for obstetrics since it was the first hospital to offer facilities for natural childbirth. Periodically, there had been discussions concerning closing SLO General.

Prior to AMI's acquisition, competition between the hospitals in the county took place primarily between French and Sierra Vista. First, the hospitals competed to attract doctors to admit to their facility. There was pressure on each hospital to satisfy the needs of the doctors who were already admitting there, since they could always admit patients to one of the other hospitals. Hospitals in San Luis Obispo purchased equipment physicians needed in order to ensure that they would continue to use their facilities. There are several examples of hospitals purchasing new equipment and updating existing equipment to attract and keep physicians. (F. 135–139)

This competition for doctors through the provision of equipment and services, especially between French and Sierra Vista, resulted in the hospitals' purchasing needed equipment and improving the quality of services. For example, such **[150]** competition had a major impact on how the present French Hospital was equipped when it was built. The equipment in the original French Hospital was described as "very poor" (Boyd, 354), and the hospital generally was considered by doctors to be the worst of the three hospitals in the city. (Boyd, 351) The equipment at Sierra Vista, on the other hand, was described as "superior." (Boyd, 352) When the new French Hospital was built in 1972, the administration "tried to furnish the necessary instruments and the equipment that would encourage physicians to use French

Hospital." (Anderson, 232) For example, special equipment for neurosurgery was provided so that a neurosurgeon in the city would use French for his surgery. (Anderson, 233)

The hospitals competed on the quality of nursing care offered patients. French had excellent nursing care prior to the acquisition, a fact acknowledged by an AMI official (Loftin, 1481), which gave French a competitive advantage. (F. 140–41) French also competed for physicians through its pediatric department, considered "outstanding" and "the best pediatric department in town." (Boyd, 376) In addition, French competed by virtue of its CAT Scanner which was superior to the one at Sierra Vista. (Boyd, 355) In 1975, French Hospital, which was still owned by Dr. French at that time, set up a heart catheterization laboratory, enabling cardiologists to diagnose heart disease. This program was viewed by French as a way of competing with Sierra Vista since it was a source of referrals. A few years after the heart catheterization program was instituted, French also instituted a heart surgery program. Mr. Anderson, a former administrator at French, noted that they regarded the service as one which would give the hospital increased census since it was not available elsewhere. (Anderson, 222) AMI recognized that such a program was advantageous to French. In noting the advantages of buying French, for example, one AMI memorandum states that the acquisition "would remove the need for Sierra Vista to develop a competitive service." (CX 38C)

During the period that the physicians owned French Hospital, they brought a number of new specialists into the French Clinic. In bringing in these physicians, the French Clinic doctors were interested "in the expertise they would bring to our role as being as complete as possible in the practice of medicine." When French Hospital was purchased from Dr. French, offers were made to physicians from outside the French Clinic group. In early 1978, three physicians accepted limited partnerships in the facility. In October, 1978, offers were made to eight other physicians, and two accepted. The loss of physicians to French concerned Mr. Carlson, the administrator of Sierra Vista. After the first offering of French partnership shares in 1978, Mr. Carlson reported to AMI that "[a]n unknown [151] factor in physician utilization of the hospital is the increasing number of physicians who have been invited to buy into French Hospital." (CX 317B) By October 1978, when the second offering was made, Mr. Carlson was even more concerned: He wrote that:

> A problem of major concern is that of competition from French Hospital. Because of doctor ownership, past increases in the number of physicians and possible future

> additions to the Clinic makes that hospital an increasingly formidable competitor for the limited number of patients in the area.

(CX 318B)

The hospitals in San Luis Obispo were careful about their rates in those areas where patients were likely to be most knowledgeable. Hospital administrators and AMI officials checked room rates both within the county and in other areas. Mr. Friedmann, who was in charge of pricing at French Hospital prior to the French acquisition, kept track of room rates at hospitals in the county and throughout the state. Mr. Friedmann suggested that such examinations had a competitive purpose. He testified:

> There is natural tendency to examine these rates in the sense that certainly you don't want to be terribly out of line or competitively out of line in the sense of, if I were overly high, I would know that maybe I have a problem within my facility as to my costs that had to be examined. Plus from a public relations standpoint, you don't want to be the highest priced show possibly in town.

(Friedmann, 1580) Documents show that AMI also was concerned with room rates in the county. An Arroyo Grande planning document includes a survey of room rates, but only those in the county. (CX 191H–I) A memorandum analyzing the upcoming French acquisition similarly noted only those rates at hospitals within the county (CX38N), the same hospitals that are referred to as French's competition. (CX38M) Another AMI memorandum suggests that there was room for Sierra Vista to adjust its rates, based on a study of room rates at hospitals in the county. (CX 479; *see also* CX480)

Evidence indicates that competition also had an effect on other charges that were likely to be "visible" to consumers, the operating room and the emergency room fees. In the Spring of **[152]** 1978, the installation of a new computer allowed French to change from a per-hour operating room charge to a unit pricing system. As a result, operating room charges were changed so that the "front-end charge" was reduced but, due to various "weighting factors," total revenue could be increased. This change, however, did result in lower operating room fees for some patients. The reduction in the "front-end charge" would become known to patients, because that was "the actual visible fee . . . that would normally be published, for instance in the paper." (Friedmann, 1583) French reduced another visible charge to patients, the emergency room charge. Doctors used the French emergency room on weekends and off-hours instead of opening up their offices. Usually there was a charge for the use of the emergency room, but it was waived when doctors saw patients under these circumstances. There was concern at Sierra Vista about the competitive moves of French Hospital. In a letter to Mr. Loftin, a local physician who practices at Sierra Vista noted the changes in fee schedules, and stated: "It is . . . becoming apparent that this hospital [French] is attempting to generate competition . . . and thus is become [sic] extremely competitive with Sierra Vista Hospital." (CX 737) The doctor went on to state that AMI should consider a decrease in its emergency room fees "to be competitive. . . ." (*Id.*) Mr. Loftin replied on February 12, 1979, while AMI was considering the acquisition of French Hospital (CX 738; *see* CX 38): "We have been aware of the competitive moves of French Hospital and will most certainly work to counteract these." (CX 738)

Other services offered by Sierra Vista faced competition from French. Sierra Vista operated a reference lab prior to the acquisition. The lab was slow to get business, however, due to "a number of factors including prices from both local competitors and the major labs in Los Angeles." (CX 452B) One such "local competitor" was French Hospital, which subsequently established a price schedule lower than Sierra Vista's. (CX 319B) In January, 1979, Mr. Carlson noted that Sierra Vista would "need to take action soon to combat this development." (CX 319B)

French Hospital hired a public relations manager who began a series of educational seminars on health issues. Mr. Friedmann, financial administrator at French and also a partner, stated that he believed that this would increase the number of patients for the medical clinic group and that "a direct derivative would be . . . that the hospital would get maybe additional census because the physicians now saw a greater number of patients than they did previously. . . ." (Friedmann, 1586) Sierra Vista had an auditorium which was used by a number of organizations for educational programs, and started its own series of programs **[153]** similar to those at French. In one report, Mr. Carlson noted that the hospital was beginning "a series of educational programs for the community under the direct sponsorship of the hospital. The majority of programs held in the hospital have been sponsored by the various agencies putting on the programs, however, I feel that additional areas of interest to the public should be addressed by the hospital." (CX 318B)

Although few doctors from outside the city of San Luis Obispo regularly used the city hospitals, the possibility that these doctors might admit some patients there imposed some competitive pressure on hospitals in the outlying areas. The existence of French as an independent hospital provided a way of bringing pressure to bear on the Arroyo Grande [AMI] administration when new equipment was needed. Dr. Schwam, who practiced at Arroyo Grande, testified:

> [M]odernizing Arroyo Grande Hospital and stimulating administration to get what we though was adequate equipment has always been a problem. . . .
>
> * * * * * * *
>
> So the medical staff had a certain amount of leverage in a sense because we could always point to French Hospital in terms of equipment that we felt that we needed and that we were not getting. Some members of the medical staff even stated that they would take their patients to French Hospital if certain basic equipment was not forthcoming.

(Schwam, 585) Dr. Schwam did not generally admit patients to French, but he used that option as a way of "alerting administration that we wanted progressive changes." (Schwam, 585–86) AMI recognized this competitive pressure. In a report prepared by the staff of AMI Vice President Norman Loftin (Loftin, 1492) concerning Arroyo Grande, it was noted that "among the physicians in the community, French is used over Sierra Vista, another American Medical International Hospital, because of the philosophy that subtly suggests to the corporation that it invest in the same quality and level of care in both Arroyo Grande and Sierra Vista." (CX 197G)

Respondents contend that due to physician polarization in the city of San Luis Obispo, there was no substantial nonprice competition between French and Sierra Vista. (*See* RB, pp. 91–98) The effects of physician polarization, to the extent it existed in San Luis Obispo, was minimal. Much of the so-called polarization was normal rivalry, a result of intense competition **[154]** among physicians for patients. (*See* F. 148–151) As the evidence cited above demonstrates, there was substantial price and nonprice competition between French and Sierra Vista, the physician polarization notwithstanding.

Respondents also contend that the absence of normal economic incentives in the hospital industry results in an "uncontrolled spiral of duplicative and wasteful purchasing" of expensive equipment, and that this is condemned by the Planning Act. (Resp. Reply Brief, p. 38) Yet, respondents also argue that there are substantial non-market constraints on hospitals regarding decisions on hospital costs and charges. (RB, pp. 56–59) The record establishes that while there might be some excesses in catering to physicians, countervailing considerations outweigh the excesses. Some equipment which was purchased by San Luis Obispo hospitals was relatively inexpensive and easy to obtain. French and AMI had procedures whereby they reviewed doctors' requests for equipment to ensure that it was necessary, financially feasible, and useful to more than one individual. Furthermore, such requests were reviewed by committees so that there is "a consensus before we expend significant amounts of money. . . ." (Carlson, 1324) Each hospital balanced its need to keep physicians satisfied with other financial considerations, including the return to the hospital. (*See* Friedmann, 1575) Finally, the health planning laws further inhibit unnecessary expenditures by hospitals since some equipment cannot be purchased without a certificate-of-need, and such certificates will not be granted if unnecessary duplication or low utilization will result. Third party payors, especially Medicare, Medicaid, Medi-Cal and Blue Cross, take a close look at hospital expenditures since they reimburse based on costs.

Dr. Lave, complaint counsel's expert witness, expressed a very relevant view of the benefits and costs of nonprice competition:

> There are always adverse effects of competition. When anybody looks at it, when a Soviet planner looks at competition, he sees excessive capacity being built in one place, some other capacity sitting idle in another place, he sees luxury here that need not be present and so on.
>
> There is always something in competition that gets people who don't understand it irritated because it always looks as if this could be done more efficiently if we had somebody in charge who could give the orders. The fact is that over time these [155] relatively minor excesses that come about because of competition are disciplined by the marketplace and help to keep the competitors on their toes and to lead to a greater efficiency.
>
> So that this is just as true with respect to hospitals as it is with other areas of the economy. I think that on balance this kind of nonprice competition is extremely productive both in terms of the quality of patient care that one would see as defined by health professionals and the quality of patient care as patients would view it, which is probably just as important as the quality of care as defined by health professionals.

(Lave, 839–40)

E. *Competitive Effects of the Acquisition*

AMI's acquisition of French Hospital has produced extremely high concentration in the hospital market in both the city and county of San Luis Obispo. By making the French acquisition, AMI increased its market share, measured by inpatient days, from 55.6 percent to 75.5 percent in San Luis Obispo County and from 57.8 percent to 87.2 percent in the city of San Luis Obispo. For market share measured by gross hospital revenues, the comparable figures are an increase from 52.2 percent to 71.3 percent in the county and from 53.3 percent to 82.4 percent in the city. The Herfindahl-Hirschman Index based on inpatient days increased from 3818 to 6025 in the county and from 4370 to 7775 in the city; based on gross hospital revenues the increase was from 3518 to 5507 in the county and from 3996 to 7097 in the city.[16] (Appendix D)

The concentration statistics do not reveal the full extent of AMI's dominance of the market. AMI's only competitor in the city of San Luis Obispo is SLO General. It is not a formidable competitor because it is relatively old, smaller than either French or Sierra Vista, and, with the exception of its obstetrics department, lacks the modern and sophisticated equipment, and in some areas the high quality nursing services, **[156]** necessary to attract doctors, and is preferred by fewer patients than French or Sierra Vista. (F. 132, 135; Boyd, 358) The only other non-AMI hospital in San Luis Obispo County is Twin Cities. This hospital is small, does not offer the range of services offered by French or Sierra Vista, and is inconveniently located for many residents of the county. (F. 14, 24, 133) As a result, neither SLO General nor Twin Cities offers effective competition to AMI's hospitals in San Luis Obispo County. Because of the substantial barriers to the construction of new hospitals in San Luis Obispo County, particularly by firms not already operating in the area, it is very unlikely that AMI will face any competition for the foreseeable future other than that offered by SLO General and Twin Cities.

Further, there are no practical substitutes for the "cluster of services" offered by AMI's hospitals. Also, governmental regulatory apparatus in no way constrains AMI's use of market power to raise prices, restrict output, or diminish the quality of the services it provides; instead, such planning laws as exist serve as barriers to new entry. Thus, evidence of extremely high market shares, high entry barriers, great disparity in size between the top firm and the other hospitals in the market, excess capacity and a relatively stagnant demand for hospital services, all confirm that AMI's dominant market power will persist.

The power which AMI has over acute care hospital services in San Luis Obispo County and the city is best expressed by Dr. Lave, complaint counsel's expert witness:

> AMI has tremendous power to maintain its prices, to get its prices and say to other people, well, of course you can always travel many miles at great inconvenience to [you] and to your family and be hospitalized somewhere else but in the meantime we have this hospital here.
>
> There is quite a substantial price premium that would be associated with their ability to be able to control these three hospitals in the county.

(Lave, 901–02)

AMI was aware of the control over health care in San Luis Obispo

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[16] The Justice Department's Merger Guidelines indicate that the Department is likely to challenge mergers increasing the Herfindahl-Hirschman Index more than 100 points where the post-merger index is above 1800 points. (47 FR 38493, 38497 [June 30, 1982])

County, which the French acquisition would confer. This is revealed by a memorandum recommending the French acquisition from AMI Vice President Dennis Danko to AMI's Contract Development Committee. Mr. Danko's responsibilities at AMI were the identification and analysis of community hospitals throughout the United States for purposes of acquisition. **[157]** Mr. Danko was a major participant in the negotiations for the purchase of French Hospital and signed the letters of intent for the transaction on AMI's behalf. His memo states:

> [W]ith the French acquisition, AMI would become the prime, if not the only, provider of health care services in the area. . . . While it is true that if we do not acquire French, our health care centers in the San Luis Obispo County region will continue to operate on a viable basis; however, we face a choice of paying a premium price, thus controlling health care services, while meeting our earnings expectations, or continue to struggle to capture basically the same patient load with French, or another operator such as N.M.E. [National Medical Enterprises], who may purchase French. It would be my recommendation that we proceed with the acquisition as outlined.

(CX 41C–D)

While Congress has "remained convinced that competition does not operate *effectively*" in the hospital field, *National Gerimedical Hospital & Gerontology Center v. Blue Cross,* 452 U.S. 378, 392 (1981) (*emphasis supplied*), the record establishes that there are substantial areas of competition in the hospital market in general, and San Luis Obispo County in particular.[17] While this competition might not be termed **[158]** "effective," as the term was used by the Congress, it is beyond doubt of sufficient significance to warrant protection.

Prior to the acquisition, AMI hospitals and French Hospital engaged in various forms of nonprice competition to attract physicians and their patients, or to retain the patronage of those physicians and patients already using their facilities. These activities have already been set forth in detail. With the French acquisition, these hospitals no longer compete against each other in this way. Mr. Danko stated in his memorandum that if the acquisition did not occur, AMI would have to "continue to struggle to capture basically the same patient load with French, or another operator such as [National Medical Enterprises]. . . ." (CX 41D) The administrator of French after the acquisition, Mr. Lauran Bowytz, recognized that competition with French had ended with the acquisition. In 1980, he was interviewed by a representative of AMI subsidiary Friesen. He noted that he cannot compete along traditional lines, such as by recruiting doctors, or "steal[ing] from S[ierra] V[ista]" because "competition is AMI." (CX 295W) An AMI Quality Assurance Report for Sierra Vista also recognized that competition between Sierra Vista and French would be curtailed:

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[17] Respondents argue that the prerequisites for a competitive market are absent from the hospital industry. (*See* RB, pp. 23–33) As complaint counsel points out, respondents are relying on conditions for a textbook model of perfect competition (Complaint counsel's Reply Brief, pp. 3–9), "but the pure model must never be mistaken for that 'competition' we wish to preserve." R. Bork, *The Antitrust Paradox* 60. Respondents also characterize the record evidence of actual competition between hospitals as "gossamer and anecdotal" (Resp. Reply Brief, p. 2), "unsupported fragments of testimony and uninterpreted excerpts from documents" (Resp. Reply Brief, p. 16), and "occasional wisps of language." (Resp. Reply Brief, p. 18) The substantial evidence relied upon in this opinion demonstrating areas of actual competition between hospitals consists of statements by credible witnesses, some of whom were respondents' officials, and contemporaneous documents written by respondents' officials. This evidence is not easily denigrated. At a minimum, the competitive effects which AMI represented would occur in Yuma, Arizona if a second hospital were to enter the market (*see* pp. 146–147 *supra*), should exist in San Luis Obispo if French Hospital were to remain an independent entity.

> For many years Mr. Carlson and his forces have challenged the French Hospital and won the battle, now *that* activity has to be curbed and a balance of cooperation mixed with healthy competitiveness has to be reached whilst retaining hard earned standards of care.

(CX 425F) (Emphasis in original) This report also recognized that AMI hospitals in San Luis Obispo find themselves in a "politically sensitive arena" because of the "monopoly of the hospital market." (CX425F) Mr. Danko stated that with the French acquisition, AMI "would become the prime if not the only provider of health care services in the area. . . ." (CX 41C)

AMI took steps to make charges uniform at all of its hospitals in the San Luis Obispo area after it acquired French. In 1980, for example, a memorandum to administrator Mr. Lauran Bowytz at French Hospital recommended that the charges for certain items be changed. It noted that "these price changes [**159**] will establish uniformity for the San Luis Obispo area." (CX 301A; *see also* CX 302A) In the Friesen report for French Hospital, Friesen noted as an "action item" to "standardize fee structure for AMI hospitals." (RX 5435Z69) On another occasion, Mr. Bowytz took advantage of the lack of restraint on AMI's pricing conduct by raising charges in order to compensate for a low patient census. (RX 5378AA) In another instance, Mr. Bowytz noted that he was implementing increases for purposes other than to cover certain costs. (CX 51A)

Thus, price competition for patients on the basis of room and board and other visible rates has been foreclosed between the two largest hospitals in the market, leaving little, if any room for price competition in the city or county. Whereas previously, doctors and patients knew that they had a viable and acceptable independent hospital to go to if they were dissatisfied with the service or price of either French or Sierra Vista, that choice no longer exists. The need for this choice is especially important in the city of San Luis Obispo since the remaining nearby alternative, SLO General, does not have the range and quality of services that the majority of physicians and fee-paying patients in the community prefer, and lacks the money to substantially upgrade its facility. Before the acquisition, the administrators of

French and Sierra Vista knew that patients and doctors had a choice nearby and this leverage increased their sensitivity to physician and patient needs.

Group purchasers of hospital services, or third-party payors, have become more aggressive in recent years in seeking lower hospital costs. (F. 183–185) Actual and potential price competition for the business of third-party payors has been restricted by the acquisition. Third-party payors have lost competitive leverage in playing off French against the AMI hospitals in the market to obtain the best price possible for their insureds. The magnitude of potential savings in this area is substantial since Blue Cross, Medi-Cal, and charge-based payers account for a substantial portion of the hospital revenues in San Luis Obispo County. Recent California legislation has provided impetus for competitive bidding, both in the public and private health insurance sectors, and Medi-Cal, Blue Cross, and preferred provider plans have already begun to engage in this process. HMOs also seek competitive bids for their hospital requirements. By acquiring its leading competitor, AMI has foreclosed independent competitive bids from French, a hospital that had a tremendous economic incentive to cut prices because of low patient census. The testimony of Mr. William Guy, the Medi-Cal Negotiator for the State of California, illustrates the competitive impact of the French acquisition on group purchasers of hospital services seeking competitive bids: **[160]**

> Well, if the major facilities which you need in order to meet the terms of the law are owned by a single entity, you hardly have an opportunity for competition. Competition is what we need within the negotiating environment to drive the most cost-effective rate for the state.

(Guy, 666)

AMI's defense relies heavily on the alleged pervasiveness of regulation and absence of price competition in the hospital industry.[18] The premise implicit in AMI's arguments is that preexisting noncompetitive conditions in an industry are a reason for upholding an acquisition against antitrust challenge. Not only does this argument fail in the face of the evidence noted above documenting the existence of competition that is worth preserving and enhancing, but it is also at odds with cases upholding the validity of Clayton Act challenges in other industries where government regulation has attenuated price and other forms of competition. *United States v. Philadelphia National Bank,* 374 U.S. 321, 368–369 (1963); *California v. Federal Power Commission,* 369 U.S. 482 (1962); *Maryland and Virginia Milk Producers Ass'n v. United States,* 362 U.S. 458 (1960); *United States v. Pacific Southwest Airlines,* 358 F.Supp. 1224 (C.D. Cal. 1973), *cert. denied,* 414 U.S. 801 (1974); *see also Federal Maritime Commission v. Seatrain Lines, Inc.,* 411 U.S. 726 (1973). The failure to protect the price and nonprice competition which exists in the hospital market by strict enforcement of the antitrust laws leaves no alternative but to abandon the market to monopolists or cartels.

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[18] Some post-acquisition evidence was received relating to rate of charge growth at French and Sierra Vista since the acquisition, the purchase of new and additional equipment, and improvements in the quality of care since the acquisition, including nursing care and food services. (*See* RB, pp. 102–109) Much of this evidence is subjective in nature, inconclusive, and entitled to little weight as post-acquisition evidence within the control of respondents. It is not possible to compare what AMI has done at French with what would have been done by the previous owners during this same period if the acquisition had not occurred, or what would have happened if National Medical Enterprises had acquired French.

The regulatory environment for hospitals in California leaves more room for effective price and service competition **[161]** than existed in many of the cases where an antitrust violation was found despite the fact that competition had been affected by comprehensive "public utility" or "rate" regulation. At the time of the *Philadelphia National Bank* decision, banks were regulated much more heavily than hospitals are now in California. Entry, branching, interest rates, and the investment and lending practices of banks were regulated to varying degrees by state and federal governments. 374 U.S. at 327–330. Service, rather than price, was the principal focus of competition among banks. *Id.* at 368.

Even when an industry is heavily regulated, any actual and potential competition that exists should be preserved and nourished by eliminating private restraints so that competition can operate to the maximum extent possible. *See Philadelphia National Bank,* 374 U.S. at 372, ("fact that banking is a highly regulated industry . . . makes the play of competition not less important but more so"). Preservation of the potential for price competition in San Luis Obispo County is especially important since California, rather than relying on government price regulation, is actively seeking to stimulate price competition among hospitals. (F. 117–122)

Service competition, like price competition, is protected by the antitrust laws. To the extent that price competition is weak or sometimes nonexistent, there is all the more reason to protect the nonprice competition that does exist. *See Northern Pacific Railway Co.* v. *United States,* 356 U.S. 1, 12 (1958), where it is stated: "All of this [foreclosure of competition] is only aggravated . . . here in the regulated transportation industry where there is frequently no real rate competition at all and such effective competition as actually thrives takes other forms."

Finally, other antitrust cases have recognized the need to protect competition in the health care field, despite the fact that in some respects health care market forces operate in unusual ways. *E.g.,* *Arizona v. Maricopa County Medical Society,* 102 S.Ct. 2466 (1982); *American Medical Ass'n,* 94 F.T.C. 701 (1979), *aff'd as modified,* 638 F.2d 443 (2d Cir. 1980), *aff'd by an equally divided court,* 455 U.S. 676 (1982); *United States v. Hospital Affiliates International, Inc.,* 1980–81 Trade Cas. (CCH) ¶ 63,721 (E.D. La 1980).

F. *Attempt to Monopolize*

Count II of the complaint charges that AMI has, with specific intent to exclude competitors and maintain the power to control delivery of hospital services, attempted to monopolize and has otherwise engaged in unfair methods of competition in the market for general acute care hospital services in San Luis **[162]** Obispo County or parts thereof. (Complaint ¶ 15) Specific acts in furtherance of this alleged conduct engaged in by AMI include the acquisition of French Hospital and the foreclosure of a competing hospital chain from purchasing French.[19] (Complaint ¶ 16)

"Monopoly power" means the power to control prices and exclude competition. *United States v. Grinnell Corp.,* 384 U.S. 563, 571 (1966) An attempt to monopolize is illegal whether or not it is successful. *Lorain Journal Co. v. United States,* 342 U.S. 143, 153 (1951). The three basic elements of the offense are (1) exclusionary or anticompetitive conduct (2) prompted by a specific intent to monopolize, (3) coupled with a dangerous probability that monopoly will result. *Swift & Co. v. United States,* 196 U.S. 375, 396 (1905); *E. I. du Pont de Nemours & Co.,* 96 F.T.C. 653, 725 (1980). Complaint counsel contend that all three elements are present in this case, and I agree.

Complaint counsel argues that the French acquisition is anticompetitive conduct designed to further AMI's attempt to monopolize, and that an anticompetitive acquisition can be the basis for a finding of attempt to monopolize. *Heatransfer Corp. v. Volkswagenwerk, A.G.,* 553 F.2d 964, 981 (5th Cir. 1977), *cert. denied,* 484 U.S. 1987 (1978); *Bergjans Farm Dairy Co. v. Sanitary Milk Producers,* 241 F.Supp. 476, 486 (E.D. Mo. 1965), *aff'd,* 368 F.2d 679 (8th Cir. 1966). *See also United States v. Grinnell Corp.,* 384 U.S. at 570–71 (monopolization). Respondents point out that evidence of anticompetitive conduct other than acquisitions was present in the above cases. (*See* Resp. Reply Brief, pp. 147–148) Respondents also reference two Commission opinions where it was held that an illegal acquisition was not sufficient, standing along, to infer an intent to monopolize. *United Fruit Co.,* 82 F.T.C. 53, 158–59 (1973), *enforcement granted in part and denied in part sub nom. Harbor Banana Distributors, Inc. v. FTC,* 499 F.2d 395 (5th Cir. 1974), *modified,* 88 F.T.C. 981 (1976); *Golden Grain Macaroni*

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[19] The allegation that AMI directed its three hospitals in San Luis Obispo County to take a united position in refusing to compete with each other by offering price and other concessions to a local HMO was dropped by complaint counsel before trial. (Tr. 74; *see* Complaint ¶ 16(c))

Co., 78 F.T.C. 63, 165 (1971), *order enforced in part*, 472 F.2d 882 (9th Cir. **[163]** 1972), *cert denied*, 412 U.S. 918 (1973), *modified*, 82 F.T.C. 1824 (1973).[20]

The acquisition in the present matter was made under entirely different conditions and with a significantly greater competitive impact than the acquisitions considered by the courts and the Commission in the cited cases. In San Luis Obispo County, AMI had a 55.6 percent share of inpatient hospital days and 52.2 percent of gross hospital revenues in the county at the time of the acquisition. The acquisition increased these market shares to 75.5 percent and 71.3 percent respectively. The market shares for the city were 57.8 percent of inpatient hospital days 53.3 percent of gross hospital revenues prior to the acquisition. AMI acquired its largest and most direct competitor increasing its market share percentages to 87.2 percent and 82.4 percent. An acquisition that eliminates the principal competitor in a market and increases market share to this degree is sufficient, in my view, to infer an attempt to monopolize the market. *See E. I. du Pont de Nemours & Co.*, 96 F.T.C. 653, 727 (1980); *Heatransfer Corp.*, 553 F.2d at 981; *American Tobacco Co. v. United States*, 328 U.S. 781, 797 (1946).

There is other credible evidence to support AMI's intent to monopolize. The exclusionary effect of the acquisition and the market power it gave AMI was clearly anticipated by the top AMI officials involved in the decision to make the French acquisition. On January 25, 1979, AMI Vice President Loftin recommended to AMI's Contract Development Committee that it authorize a letter of intent to purchase French Hospital. Mr. Loftin sought the letter of intent, at least in part, because he believed that National Medical Enterprises ("NME"), a national hospital chain which owned Twin Cities Hospital in northern San Luis Obispo County, also was interested in the hospital. In his memo he wrote:

> We do know that National Medical Enterprises is also currently interested in French and that preliminary discussions have been held. Due to his fact, we would like to proceed as soon as possible.

(CX 38B) **[164]**

On February 9, 1979, AMI Vice President Danko wrote to the AMI Contract Development Committee recommending the French acquisition:

> *[W]ith the French acquisition, AMI would become the prime, if not the only, provider*

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[20] In *United Fruit*, the hearing examiner [ALJ] found lawful competitive business motives for the challenged acquisition (82 F.T.C. at 158), and in *Golden Grain Macaroni*, the Commission considered that the acquisition was motivated in part by a desire to replace the loss of production facilities. (78 F.T.C. at 165)

> *of health care services in the area.* This may be viewed by some in the medical community and others negatively. However, in the long run the positives would overcome the negatives. There also exists a real possibility that with or without French, the local county-owned hospital (114) beds may close. Currently, one-half of its bed complement is not in operation; it has lost its JCAH accreditation; and the county is supposedly subsidizing the hospital in excess of $1.0M/yr. Note that this hospital is predominately providing O.B. services at this point, plus hemo.
>
> While it is true that if we do not acquire French, our health care centers in the San Luis Obispo County region will continue to operate on a viable basis; however, we face a choice of paying a premium price, *thus controlling health care services,* while meeting our earnings expectations, *or continue to struggle to capture basically the same patient load with French, or another operator such as N.M.E., who may purchase French.* It would be my recommendation that we proceed with the acquisition as outlined.

(CX 41C–D) (emphasis supplied)

These contemporaneous business documents written prior to the acquisition by the relevant AMI officials intimately involved in evaluating the acquisition clearly establish a specific intent to monopolize. These documents are entitled to much greater weight than after-the-fact explanations offered at trial by interested AMI witnesses.[21] *See United States v. United States Gypsum Co.,* 333 U.S. 364, 395–96 (1948); *National Commission on Egg Nutrition,* 88 F.T.C. 89, 177–178 (1976), *aff'd,* 570 F.2d 157 (7th Cir. 1977), *cert. denied,* 439 U.S. 821 (1978); *Adolph Coors Co.,* 83 F.T.C. 32, 185 (1973), *aff'd in part and rev'd in part on other grounds,* [165] 497 F.2d 1178 (10th Cir. 1974), *cert. denied,* 419 U.S. 1105 (1975).

It is concluded that AMI engaged in exclusionary and anticompetitive conduct that was prompted by a specific intent to foreclose competitors and control hospital services in the city of San Luis Obispo and San Luis Obispo County. Further, there was a dangerous probability that AMI would be successful in monopolizing the markets. In fact, it can be concluded that success was achieved. A quality assurance report, written in April 1980, made reference to the "monopoly of the hospital market" in respect to Sierra Vista and French. (CX 425F) As a result of the acquisition, AMI achieved over 80 percent of the city market and over 70 percent of the county market for hospital services. Judge Learned Hand, in *United States v. Aluminum Co. of America,* 148 F.2d 416, 424 (2d Cir. 1945), stated that 33 percent of a market does not constitute a monopoly and it is doubtful whether 760 or 64 percent would be enough. He probably would have agreed that in excess of 70 percent or 80 percent would be enough. I believe it is enough to indicate a strong probability of achieving monopoly, especially when the barriers to entry are high and the remaining competition is very weak. *See Heatransfer Corp.,* 553 F.2d at 981; *United*

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[21] *See* F. 164 n. 15, n. 16.

States v. Grinnell Corp., 384 U.S. at 571; *United States v. American Tobacco Co.*, 328 U.S. at 797.

Complaint counsel also asserts that there is other evidence of AMI's intent to monopolize. (CB, pp. 62–65) Complaint counsel cites evidence that AMI was aware of and concerned about competitive moves by French, and stated an intent to counter these moves. This evidence may reflect reasonable competitive efforts to meet competition, or at least it can be interpreted in that manner, and it will not be considered as evidence of an intent to monopolize.

Complaint counsel also contends that AMI paid a "premium price" for French Hospital, relying upon Mr. Danko's memorandum of February 9, 1979, quoted above, that "we face a choice of paying a premium price, thus controlling health care services, while meeting our earning expectations. . . ." (CX 41D) According to complaint counsel, the short of the matter is that AMI was eager to eliminate actual competition from French and potential competition from National Medical Enterprises and was willing to pay a premium price in order to control the market. Complaint counsel thus attaches great significance to the former phrase (premium price) while apparently ignoring the latter (earning expectations).

The evidence concerning whether or not AMI paid a premium price for French is set forth in detail in the findings of fact. (F. 163–173) The evidence does not establish whether or **[166]** not AMI paid a premium price for French, or if a premium price was paid, whether any part of that price was attributable to a design to foreclose competitors and control the market. Contemporaneous AMI documents indicate that some AMI officials believed the price was a premium; these same documents also indicate that the officials believed that at the price paid AMI expected to meet its profit objectives: "In summary, the acquisition of [French] appears to be a unique opportunity for AMI. It would be immediately profitable, achieve our rate of return objective and provide additional growth." (CX 38G; *see also* F. 173) It is therefore plausible to assume that the price that AMI paid was a reasonable price based on legitimate profit concerns. Accordingly, the issue of whether AMI paid a premium price for French Hospital, and whether any part of that price was attributable to AMI's monopolistic intentions, has not been proved by substantial evidence.

G. *AMI's Efficiencies Defense*

1. A Factual Analysis

Respondents offered evidence that the acquisition of French has created the potential for far-reaching cost savings which could be effected by implementation of recommendations set forth in a study entitled "Cost Savings Expected From Consolidation of French and Sierra Vista Hospitals." (RX 5614A–S) The study indicates that this consolidation could result in annual operating cost savings of at least $1,238,000 and capital cost savings of at least $12,200,000. In addition to these monetary savings, an enhancement in the quality of care is expected. The study was prepared in connection with this proceeding by employees of AMI and its wholly-owned subsidiary, Friesen, under the direction of Mr. Mittelstaedt, a Vice President of Friesen. AMI's counsel helped formulate the questions to be addressed by the study.

The study estimated the operating cost savings of consolidation by comparing the unit costs of particular ancillary and support services provided at both hospitals, then assuming that the services could be provided at one location for both hospitals at the lower unit cost. The study also estimated the costs of personnel whose positions would be eliminated upon consolidation. The largest portion of savings would result because of capital expenditure savings made possible by consolidation. This figure was arrived at by comparing the cost of the capital improvements needed to maintain Sierra Vista as a "first-rate hospital," should there be no consolidation, with the capital costs of consolidating French and Sierra Vista. Further, respondents contend the $1.238 million per year operating cost savings does not include savings which possibly will be achieved from increased patient volumes arising out of **[167]** consolidation, because there will be no need in the future for two departments to purchase the same equipment where the consolidated patient volume only justifies one.

The record indicates that consolidation of services between hospitals is unlikely to be achieved without common ownership. As a practical matter hospitals simply are not willing to give up services to other independently-owned hospitals. The fact that hospitals attempt to preserve their revenue flows and physician loyalties precludes consolidation of important services between noncommonly-owned hospitals. According to AMI, this matter of consolidation has not been put to the Executive Committee of AMI because of the present litigation. Disentangling the two hospitals in the event they were consolidated and AMI subsequently ordered to divest French would be costly. Further, it would disrupt the community; in particular, it would disrupt the physicians who would have oriented their practices in accord with the distribution of services recommended by Friesen, and would then have to readjust in the event of divestiture.

Friesen recommended the "consolidation of the two facilities under common management while retaining the operation of the two separate physical facilities." (Mittelstaedt, 1027) Under this strategy, the operations of French and Sierra Vista would be merged under a single administrator and a single hospital name, the medical staffs would be unified into a joint medical staff, and services would be divided between the two facilities. Among the services which would be located exclusively at French are pediatrics, obstetrics, clinical laboratory, ophthalmology, cardiology, and pathology. Among the services which would be located exclusively at Sierra Vista are trauma, orthopedics, neurosurgery and oncology. Both facilities would continue to provide medical/surgical services as well as intensive care and coronary care services.

It is not clear that consolidation of French and Sierra Vista will occur, even assuming AMI is permitted to keep French Hospital. Consolidation of French and Sierra Vista, as recommended by Friesen, would require the preparation of detailed implementation plans and formal approval of the Executive Committee of AMI's Board of Directors. There, is no assurance that those individuals and committees at AMI who would have to authorize the over $8 million for the consolidation would act to do so. AMI management does not always agree with the conclusions of Friesen (Loftin, 2497), nor necessarily [168] follows Friesen's recommendations.[22] (Loftin, 2492) Consent of the hospitals' local boards also will have to be obtained.

A number of practical barriers stand in the way of a consolidation of the scope Friesen recommends. No consolidation on this scale had even been done before. (Derzon, 2075) A number of doctors told Friesen that it was their belief that AMI did not have the "guts" to tackle some of the tough issues associated with a consolidation.[23] Doctors who currently practice at one hospital will fight the idea of their specialty being moved to the other. Finally, AMI would have to obtain approval from the local HSA and the state before making most of the capital expenditures required to consolidate the hospitals. Government approval is subject to a number of contingencies beyond AMI's control, including how much delay there might be before government approval is granted or denied. Since consolidation is one of Mid-Coast HSA's goals, it can be expected that Mid-Coast HSA will work with AMI at some plan of consolidation, but not necessarily that proposed by Friesen, since the consolidation plan does not contemplate the elimination of excess hospital beds. (*See* F. 202)

It is questionable whether economies of scale, such as the $1.238 million in operating expenses envisioned by RX 5614, actually can be gained through consolidation. Dr. Schramm, respondents' economic expert, has noted that there is inconsistent evidence concerning whether economies of scale exist for hospitals. He has noted that "[w]hen combined, existing research suggests that the economies of scale attached to hospital size and, presumably, to the size of any hospital entity however formed, may be illusive." (CX 1048P) **[169]** Dr. Schramm also has written:

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[22] Testimony elicited from AMI's top officials, Mr. Weisman and Mr. Loftin, was to the effect that they would recommend implementation of the Friesen consolidation plan. (Weisman, 1746; Loftin, 1534) Mr. Weisman testified that he would "unequivocally and enthusiastically" support the proposal. (Weisman, 1747) However, it is only logical to assume that the "Friesen proposal" might undergo substantial revision prior to any actual approval and implementation.

[23] At the August, 1981 presentation of Friesen's findings and recommendations to the French and Sierra Vista medical staffs, some support was expressed by local physicians for the concept that French and Sierra Vista be consolidated. The specialties of Drs. Stahl and Harvey, two of the physicians expressing support for the consolidation, would benefit from the proposed consolidation, and their testimony must be weighed in that vein.

> [C]onsolidations undertaken to achieve efficiency, economic security, operating surpluses and improved capabilities for meeting future demands may be ill-advised. The consolidation process itself is complicated, costly and uncertain. Those contemplating a merger should recall that the return-to-scale efficiencies expected in many mergers are never realized.

(CX 1048T)[24]

AMI did not take any significant steps toward consolidation of French and Sierra Vista services during the 17 months between AMI's acquisition of French and the time it learned of the Commission's investigation of the acquisition. After the acquisition was completed, Friesen reported to AMI that consolidation would produce "somewhat, not enormously, potential lower costs," and "modest" increased profitability. (RX 5435C, Z61; Mittelstaedt, 1109) The administrator of Sierra Vista, in an August 1981 memorandum, also indicated that he did not expect major cost savings to be achieved through consolidation: **[170]**

> It was my hope that our long range plans would permit consolidation of some services with the eventual objective of at least a slight decrease in the rate at which expenses are increasing. Even though such cooperative efforts would not necessarily be of major dollar savings, they would have been at least symbolic of our united efforts to hold down costs.

(CX 1063A)[25]

Mr. Mittelstaedt made a number of questionable assumptions and omissions in his study which affect his results. To calculate the operating cost savings resulting from consolidation, Mr. Mittelstaedt compared the unit costs of particular services provided at each hospital, then assumed that the service could be provided at one location for both hospitals at the lower unit cost, even though in some instances the service would be moved from the lower cost hospital to the higher cost hospital. (*See* F. 214) In addition, a portion of the savings are due to more effective purchasing arrangements. Consolidation is not necessary to achieve these savings; joint purchasing involving separately-owned hospitals is fairly common in California.

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[24] Dr. Schramm also cautioned that consumers may see less of the benefits of consolidation than of its costs:

> [T]he merger movement [in the hospital industry] must be seen in the light of consumer satisfaction. Clearly, absolute consumer choices suffer as consolidations advance. This is traditionally rationalized by citing reductions in unit prices that follow consolidation. Interestingly, however, prices do not always reflect the savings of consolidation and artificial price settings must be controlled through regulation. The apparent risk in consolidation from the consumer perspective is that prices may not reflect true savings. The costs of consolidation are expressed as both higher market prices and lost flexibility in the market. Moreover, consumers generally are deprived of product choice even though, as is often argued, the quality of products and services may improve.

[25] AMI has listed possible savings already realized from use of a mobile van with echocardiography and ultrasound equipment, a joint system for maintenance of biomedical equipment, a joint reference laboratory for physicians at French, sharing of computer services, and joint hiring of an anesthesiologist. (*See* F. 224–230) These purported savings are minimal at best, and most could be realized without any consolidation such as is proposed by the Friesen study.

RX 5614 ignores the cost of capital for the expenditures required to consolidate French and Sierra Vista. Approximately $8.7 million in renovations and new construction (in 1982 dollars) is required to effect the consolidation set forth in RX 5614. If AMI financed the consolidation project at 10%, the average cost of capital to AMI, the annual cost of capital for the consolidation would be at least $870,000. RX 5614 also does not consider the cost of depreciation on newly-constructed facilities and renovations built in the course of consolidation. Depreciation is usually treated as an expense. (*See* CX 38H, J–K- Depreciation on the $2,103,400 of new construction over 40 years would be approximately $52,585 per year. (*See* 38J) If the renovations were also depreciated on the same basis, then there would be an additional expense of almost $165,000. [171]

RX 5614 assumes that consolidation of the emergency rooms at French and Sierra Vista would eliminate the need for French's contract with a physician group to provide medical coverage at its emergency room, and thereby save $204,000. This savings assumes that the physician group covering Sierra Vista's emergency room, which is also under contract, could handle an increase in the number of emergency room visits of more than 50%, and would handle this increase without insisting on greater compensation for its services. RX 5614 also states that consolidation would make it unnecessary to have certain supervisory personnel at both Sierra Vista and French (for example, two administrators or two directors of nursing), and so permit the elimination of 12 supervisory positions, with annual savings of approximately $419,000. It also assumes that each supervisor in charge of activities at both hospitals (for example, the director of nursing or the x-ray chief) will have an assistant who can routinely exercise responsibility for on-the-spot decisions when the supervisor is not present. This projected cost savings would be diminished to the extent that the supervisors and assistants whose responsibilities are increased as a result of the elimination of supervisory positions, ask for, and receive, increased compensation for their efforts—a possibility acknowledged by Mr. Mittelstaedt. (Mittelstaedt, 1129–31) Finally, even if successfully implemented, the annual cost savings through elimination of supervisory positions would be less than the projected $419,000 in the first three years following consolidation, since RX 5614 assumes it would take at least three years to implement the personnel reductions.

The projected operating cost savings for laboratory tests ignores the need to maintain two laboratories even after consolidation. RX 5614 projects annual costs savings of $160,000 on the assumption that all laboratory test performed at French and Sierra Vista could be performed at one laboratory facility located at French. Mr. Mittelstaedt predicted that switching Sierra Vista's lab work to French will achieve those savings even though French's per unit cost for lab work is much higher than Sierra Vista's. (*See* RX 5614H) Also, as Mr. Mittelstaedt acknowledged in his testimony, it would still be necessary to have a "stat" laboratory at Sierra Vista to perform tests where results are needed immediately. (Mittelstaedt, 1057) Mr. Mittelstaedt's testimony about the economies of increased volume at a centralized facility (Mittelstaedt, 1048) suggests that "stat" tests performed at Sierra Vista will be more expensive after consolidation than before. This added expense offsets some or all of whatever savings might occur by having the remainder of Sierra Vista's **[172]** laboratory tests performed along with French's tests at French.[26]

RX 5614 concludes that consolidation will permit AMI to save $38,000 per year by consolidating the contracts with outside laundry firms of the hospitals. This assumes, without explanation, that the same volume of laundry would cost less under one contract for both French and Sierra Vista than under two separate contracts with the same laundry. There is nothing in the record explaining why it is necessary for both French and Sierra Vista to be owned by AMI to gain whatever advantages there may be to joint purchasing of laundry services, nor is there any explanation why this savings already has not been realized by AMI since institution of joint purchasing of laundry services would be simple to commence and to terminate, if necessary. RX 5614 also concluded that, through consolidation, $89,000 could be saved through purchasing of food supplies for French at the price paid by Sierra Vista. This conclusion does not take into account the possibility that French used food supplies of higher quality than those Sierra Vista uses, or offers a menu requiring more expensive food than Sierra Vista uses.

There would be a great number of decisions AMI would have to make to perform the variety of tasks required by consolidation. Mr. Mittelstaedt asserted that there would be no costs to AMI involved in the administrative expense of the employees making those decisions. French and Sierra Vista are two miles apart. RX 5614 does not take into account the costs of transporting personnel and goods between French and Sierra Vista after consolidation. The supervisors listed on RX 5614, some of whom would be in charge of activities at both French and Sierra Vista after consolidation, periodically might have to shuttle back and forth between the facilities. It would also be necessary to transport specimens between the Sierra Vista and the consolidated clinical laboratory and pathology department at French, and to deliver supplies from the central inventory facility at one hospital to the other hospital.

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[26] The joint laboratory may prove impractical, much like the mobile van service instituted by AMI, which was questioned in the beginning by knowledgeable AMI officials (*see* F. 225), and which lasted only two years before each hospital went back to using its own equipment. (*See* F. 224)

In short, it is unlikely that the consolidation of French and Sierra Vista, should it occur, will result in the cost savings projected by AMI. If one includes only the cost of **[173]** capital expense and the depreciation expense, the annual potential savings drop from $1.2 million to about $160,000. Other assumptions and omissions noted above will reduce these savings even further.

Most of the savings projected by Friesen are from capital cost savings, which it suggests, will be in excess of $12.7 million. This figure represents the difference between the $20.9 million in capital improvements required to maintain Sierra Vista as a first-rate independent hospital if consolidation does not occur, and the $8.1 million required to consolidate services at both facilities.[27] In addition to the obstacles to any consolidation which may prevent its being completed, there are a number of reasons why AMI may not spend $20 million plus to renovate Sierra Vista. First, there is no proof that such expenditures are necessary. Of the $20.9 million in capital expenditures, over $17 million are expenditures which AMI claims are needed at once. All of these problems existed before AMI acquired French, but AMI has not found it necessary to make such expenditures up to this time. Sierra Vista is already a first-rate hospital, and Mr. Mittelstaedt admitted that more modest changes could be instituted which would maintain the status quo at Sierra Vista. The suggested changes might improve the facility, but one may reasonably question how dire the need for such changes really is. Secondly, assuming *arguendo* that such changes are needed, AMI may not be willing to spend almost $21 million to make them in a market area that "does not present an ideal situation in terms of market growth and development" and where "[g]rowth in the community is not expected to be high enough to justify major capital expenditures across the board of AMI hospitals." (RX 5435Z66) In fact, AMI could probably build a new hospital for less than $20.9 million. In April 1981, AMI Executive Vice President R. Bruce Andrews told a group of security analysts: "We are still building hospitals at costs averaging $50,000 - $60,000 per bed, fully equipped, particularly in rural or semi-rural areas." (CX 430Q) Using Mr. Andrews' figures, AMI could build a new Sierra Vista, from the ground up—with the 50 bed addition contemplated by RX 5614—for approximately $13 million, or $7 million less than the proposed renovation of Sierra Vista. [174]

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[27] Whether consolidation or capital improvements occur, the costs associated with the capital improvements will be added to the hospitals' basis for computing costs and passed on to patients. (*See* F. 33) Thus, one could question whether any "efficiencies" have been realized for consumers.

AMI would need a certificate-of-need to make the changes envisioned by RX 5614. California's health planning authorities will closely scrutinize such a large proposed capital expenditure (Johns, 1879–1883), both as to whether the improvements are really necessary and whether more modest improvements would be sufficient. In addition, more than $3.1 million of the proposed capital expenditures, for addition of 50 beds in the late 1980's, may not be approved. San Luis Obispo County is overbedded and is likely to remain so for some time in the future. Thus, California's health planning authorities are unlikely to approve additional beds in the area. The original Friesen reports for San Luis Obispo noted that the HSA "did not see a need for additional beds in the San Luis Obispo County planning area.... Any program involving the addition of beds will be difficult." (RX 5435U)

To the extent that AMI spends less than $20.9 million to renovate Sierra Vista, the alleged savings realized by consolidating are correspondingly reduced. It is in AMI's interest to make these capital costs appear as high as possible to accentuate the supposed savings to be realized from consolidating with French. This would explain some of the inconsistencies between the $20.9 million figure and other evidence in the record. For example, AMI has already applied for a certificate-of-need for a more spacious emergency room at Sierra Vista. (Carlson, 1344–45) This project may obviate the need for part of the construction program outlined at RX 5614R–S, particularly the $900,000 temporary relocation of the emergency room and the $11,500,000 for new construction. Also, most of the $20.9 million would go for new construction which would cost $160 (in 1982 dollars) per square foot. (RX 5614N)[28] The Friesen reports, which were also overseen by Mr. Mittelstaedt, projected the cost of new construction at $120 per square foot (in 1981 dollars). (RX 5435Z65) It seems unlikely that the $40.00 per square foot difference is due entirely to one year of inflation.

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[28] This is the price for new construction needed as part of the consolidation with French. (RX 5614N) It is assumed that the cost is the same for new construction required under the plan to renovate Sierra Vista.

2. Legal Analysis

The Commission recently stated the position that efficiencies resulting from a merger cannot be used to justify a merger whose legality has been challenged under the antitrust laws: **[175]**

> While [evidence of some types of efficiencies] is appropriate for consideration by the agency in the exercise of its prosecutorial discretion at the pre-complaint stage, the Commission believes that there are too many analytical ambiguities associated with the issue of efficiencies to treat it as a legally cognizable defense.

Statement Of Federal Trade Commission Concerning Horizontal Mergers, at 9. Chairman Miller dissented on this point, stating that he "believes that scale-type efficiencies should be considered as part of the legal analyses. . . ." *Id.* at 9 n.22.

Cases decided over the years are generally interpreted as rejecting efficiency arguments in merger cases. In *FTC v. Procter & Gamble Co.*, 386 U.S. 568 (1967), the Supreme Court stated: "Possible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economies but struck the balance in favor of protecting competition." *Id.* at 580. The Court reached this conclusion despite the existence of internal Procter & Gamble memoranda which predicted that the merger would lead to large cost savings in promotion, sales, and distribution. *See Procter & Gamble Co.*, 63 F.T.C. 1465, 1541–42 (1963).

This holding in *Procter & Gamble* followed logically from the Court's earlier reasoning in *United States v. Philadelphia National Bank*, 374 U.S. 321 (1963):

> We are clear, however, that a merger the effect of which "may be substantially to lessen competition" is not saved because, on some *ultimate reckoning of social or economic debits and credits*, it may be deemed beneficial. A value choice of such magnitude is beyond the ordinary limits of judicial competence, and in any event has been made for us already, by Congress when it enacted the amended § 7.

Id. at 371 (emphasis added).

Further, in *Ford Motor Co. v. United States*, 405 U.S. 562, (1972), the Supreme Court stated: "It is argued, however, that the acquisition has some beneficial effect in making Autolite a more vigorous and effective competitor . . . than Autolite had been as an independent. But what we said in *United States v. Philadelphia National Bank* . . . disposes of that argument." *Id.* 569–570 **[176]**

Other considerations militate against accepting at face value an efficiency defense. It is extremely difficult for the fact finder to measure the existence and magnitude of claimed efficiencies because they often involve assumptions, overstatements, speculations, and questionable methodology offered by an interested party who has control of the supporting information. Judge (then Professor) Posner has termed efficiencies in merger cases "an intractable subject for litigation." R. Posner, *Antitrust Law* 112 (1976) The illusive nature of alleged efficiencies and resulting cost savings has been clearly stated by respondents' expert, Dr. Carl Schramm, in writings published prior to this litigation. (*See* p. 168–169 *supra; see also* F. 211) It is also difficult to ascertain with reasonable certainty which asserted savings can, or cannot, be effectuated through other means much less anticompetitive than a merger.

It also is extremely difficult to measure how much increased efficiency is needed to outweigh the expected effects of a merger in terms of an increase in market power. Concerning the trade-off between market power and efficiency, Judge (then Professor) Bork concluded that "[p]assably accurate measurement of the [required information] is not even a theoretical possibility; much less is there any hope of arriving at a correct estimate of the hypothetical situation." R. Bork, *The Antitrust Paradox* 125 (1978).

The difficulties which some learned authorities have posited in attempting to accurately gauge the efficiencies of a merger are present in this proceeding. Attempting to balance alleged cost savings versus an anticipated increase in market power (the anticompetitive effects of which are demonstrated in this record) and a possible loss of consumer satisfaction,[29] together with the Commission's policy decision in its Statement Of Federal Trade Commission Concerning Horizontal Mergers, make it unwarranted based on the record and inappropriate under legal precedent to sustain respondents' attempted efficiencies defense. **[177]**

H. *The Planning Act Does Not Confer an Antitrust Exemption*

Respondents contend that the challenged acquisition is not subject to the antitrust laws. The National Health Planning and Resources Development Act ("NHPRDA"), 42 U.S.C. 300k–300s (1976 & Supp. Iv 1980), depends for its effectiveness on voluntary actions by providers to reduce excess hospital capacity. The local implementing agency, the Mid-Coast Health Systems Agency, had advocated mergers of hospitals in order to alleviate over-capacity and duplicative hospital services in San Luis Obispo. AMI further contends that its acquisition of French and its plans to merge that facility with Sierra Vista were intended and reasonably calculated to advance that goal. Thus, according to respondents, an antitrust exemption in this case is necessary to make the Planning Act work. (RB, p. 1)

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[29] Dr. Schramm, respondents' expert, has noted this possibility: "Interestingly, however, prices do not always reflect the savings of consolidation and artificial price settings must be controlled through regulation. The apparent risk in consolidation from the consumer perspective is that prices may not reflect true savings. The costs of consolidation are expressed as both higher market prices and lost flexibility in the market." (CX 1048S)

The current system of health planning was established by Congress in 1974 when it enacted NHPRDA.[30] This legislation set up a series of mandatory Health Systems Agencies (HSAs) which cover every area in the country. HSAs are responsible for health planning within each area and are private, rather than governmental organizations. Congress required that the HSAs be made up of both providers and consumers, with consumers being the majority and adequately reflecting the various groups represented in the local population. In NHPRDA, Congress required HSAs to perform certain specific functions. (42 U.S.C. 300k–1, 300l–4(c)(1)(A) (1976 & Supp. IV 1980) These functions are to produce health systems plans; to conduct project reviews, including certificate-of-need reviews; to do "Proposed Uses of Federal Funds" reviews; and to conduct other reviews as requested by other agencies. California has fourteen HSAs. (CX 533B) HSA 8, the Mid-Coast HSA, includes the counties of San Luis Obispo, Monterey, San Benito and Santa Cruz. (RX 5466F–G, T, Z7)

A Health Systems Plan is a document prepared by the HSA which discusses the health care needs and goals of the health systems area. It is approved at the state level and then by federal officials who review it for "scope, quality, and consistency with federal planning policies." (Johns, 1973) Health systems plans often make general recommendations **[178]** concerning how certain goals should be achieved; however, the HSA has no power to enforce these recommendations. Furthermore, plans do not make recommendations about specific institutions.

HSAs are also required to produce documents called Annual Implementation Plans ("AIPs"). The AIPs are supposed to take the recommendations contained in the health systems plan and discuss when and how they should be implemented. "These recommendations [in the AIP] usually take the form of committees should be formed, meetings should be held, studies should be undertaken and so forth." (Johns, 1915) Like the Health Systems Plans, AIPs do not specify which hospitals should undertake any of the steps specified in the plans. (*Ibid.*)

Another major function of HSAs is making recommendations on certificates-of-need ("CON") applications. Each state is required to have a CON program; before a provider can undertake certain projects, it must first receive a CON. The granting of a CON represents a judgment by the state that a proposed project is consistent with local needs and state policies. Projects requiring CONs (except in exceptional circumstances) include new hospitals, expansion of bed capacity at existing hospitals (except for small increases by hospitals with high occupancy rates), transfer of beds from one license classification to another, and other major capital expenditures for a hospital. (*See* F. 84–86) Federal law does not compel states to require a CON for a change of ownership not also involving changes in services or bed capacity. (42 U.S.C.A. 300m–6(d)(1) (West Supp. 1982)) California law expressly exempts acquisitions of hospitals from CON review of capital expenditures. (*Cal. Health & Safety Code* Section 437.10 [Deering Supp. 1983]; *see also* RX 5821Z5; Johns, 1915)

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[30] *See National Gerimedical Hospital & Gerontology Center v. Blue Cross of Kansas City,* 452 U.S. 378 (1981) for a succinct discussion of the federal health planning laws.

In California the state planning agency, required by NHPRDA, is the Office of Statewide Health Planning and Development ("OSHPD"). This office passes on CON applications and produces a statewide health plan which makes policy recommendations concerning health care needs of the state. This office has no power to enforce its recommendations. California also has an Advisory Health Council which performs the functions which the NHPRDA specifies are to be performed by a Statewide Health Coordinating Council (SHCC).

The OSHPD and other organizations have consistently noted that extensive excess capacity exists throughout California. According to one estimate, there are about 10,000 excess beds in the state. In addition, it was also determined that there were excesses in "nearly every conceivable type of service in the state." (Johns, 1912–13) Nearly every HSA in its health systems plan notes the existence of excess capacity and makes some general recommendations concerning its elimination. **[179]**

Prior to the acquisition of French, the Mid-Coast HSA had determined in the 1978–1983 Health Systems Plan and the 1979–1984 Health Systems Plan that excess beds existed and would exist in the future. The 1978–1983 Plan, for example, noted that by 1983, San Luis Obispo County would have an excess of 169 medical-surgical beds (RX 5466Z178); 12 perinatal beds (RX 5466Z275); and 19 intensive care/coronary care beds. (RX 5466Z260) The 1979–1984 Health Systems Plan also found an excess in medical/surgical beds (RX 5467Z190); pediatric beds (RX 5467Z225); intensive care/coronary care beds (RX 5467Z280); and perinatal beds. (RX 5467Z295) Mid-Coast HSA has long considered consolidation of services as a solution to the problem of excess capacity. (*See e.g.*, RX 5460Z39, Z42; RX 5461Z1–Z6, Z11–Z14; Z30; RX 5462Z11, Z12, Z15, Z17; RX 5466P, Z57, Z181, Z209–Z211, Z265–Z266, Z283–Z285, Z290–Z291)

Although Congress allowed the planning authorities veto power over the addition of unneeded new health care facilities through the CON process, reductions in unneeded existing facilities and services were to be implemented through the voluntary efforts of providers:

> The apparently modest initial means of implementing health plans, seeking the assistance of individuals and entities in the health service area to do so, is in fact the most important method available. . . . [T]he agency must be willing to seek the cooperation of established health entities in the community including physicians, hospitals, and HMOs.

H.R. Rep. 1382, 93d Cong., 2d Sess. 60. *See* Conf. Rep. No. 1640, 93d Cong., 2d Sess. 69, 73 (1974), *reprinted in* 1974 U.S. Code Cong. & Ad. News 7971 at 7979, 7983.

AMI did not consult with the Mid-Coast HSA concerning its plans for the acquisition of French Hospital, nor did AMI consult with the HSA concerning its plans for consolidation of French and Sierra Vista. Since acquiring French Hospital, AMI has not closed any hospital beds. The consolidation of French and Sierra Vista set out in the study prepared by Mr. Mittelstaedt for this proceeding also would not result in any reduction in beds. Further, no individual service will experience a net reduction in beds; the excess beds simply will be shifted from one hospital to another. For example, in 1985 San Luis Obispo County will have an excess of 116 medical/surgical beds. The proposed consolidation of French and Sierra Vista contemplates reducing the number of [**180**] medical/surgical beds at French by 18 and increasing them by the same amount at Sierra Vista. In 1985 there will be an excess of nine perinatal or obstetric beds. AMI proposes to move the 12 existing obstetric beds at Sierra Vista to French. In 1985 there will be an excess of 10 pediatric beds; AMI plans to supplement the 10 beds at French with 6 additional beds now at Sierra Vista. Finally, in 1985 there will be an excess of 15 ICU/CCU beds. (RX 5469Z21) AMI plans no change in the 8 ICU/CCU beds which exist at each hospital. (RX 5614L–M)

In addition to being concerned about excess beds, the Mid-Coast HSA also was concerned with unnecessary duplication of services. Rather than act consistently to reduce duplicative services where ever possible, AMI in its consolidation plan for French and Sierra Vista has decided selectively which HSA goals it wishes to advance and which it does not. Again, its actions suggest that it is not concerned initially or primarily with furthering the HSA's goals.

Thus, respondents' position that the acquisition of French was "intended" to advance the goals of the local HSA (RB, p. 1) is not supported by the record. AMI's concern was entirely profit-motivated, to make an acquisition that would meet its profit objectives,[31] while enabling it to control health care services in San Luis Obispo County.[32] [181]

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[31] Prior to making a commitment to purchase French, AMI officials wrote:

> In summary, I view French as a viable, productive acquisition. The $11.0 million purchase price for the hospital equates to nearly $80,000/bed, a premium price. However, the necessary bottom line can be met and exceeded.

(CX 41C)

(footnote cont'd)

The Supreme Court has determined that NHPRDA does not provide a blanket antitrust exemption for conduct alleged to be consistent with the plans of an HSA; nor is such conduct immunized from antitrust scrutiny because it is intended to aid implementation of an HSA plan. In *National Gerimedical Hospital & Gerontology Center v. Blue Cross of Kansas City,* 452 U.S. 378 (1981), the court held that although Blue Cross may have acted with only the highest motives in seeking to implement the plans of the local HSA, it cannot defeat an antitrust claim by the assertion of immunity from the requirements of the Sherman Act. The court further noted that implied antitrust immunity can be justified only by a convincing showing of clear repugnancy between the antitrust laws and the regulatory systems. Even when an industry is regulated substantially, this does not necessarily evidence an intent to repeal the antitrust laws with respect to every action taken within the industry. An intent to repeal the antitrust laws is much clearer when a regulatory agency has been empowered to regulate the type of conduct under antitrust challenge.

The action challenged in *National Gerimedical Hospital* was neither compelled nor approved by any governmental regulatory body. Instead, it was a "spontaneous response" to the finding of only an advisory planning body, the local HSA, which, under the NHPRDA, had no regulatory authority over health-care providers. The court held that the application of the antitrust laws to the Blue Cross conduct would not frustrate a particular provision of NHPRDA or create a conflict with the orders of any regulatory body; nor is NHPRDA so incompatible with antitrust concerns as to create a "pervasive" repeal of the antitrust laws as applied to every action taken in response to the health-care planning process. 452 U.S. at 393. [182]

National Gerimedical Hospital governs AMI's claim of immunity in this case. Like Blue Cross's policy, AMI's acquisition was neither compelled nor approved by any governmental, regulatory body. No regulatory system applied to the acquisition because neither state nor federal law required or provided for issuance of a certificate-of-need for hospital acquisitions. The HSA did not review or approve of the

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> In summary, the acquisition of [French] appears to be a unique opportunity for AMI. It would be immediately profitable, achieve our rate of return objective and provide additional growth.

(CX 38F)

[32] Mr. Dennis Danko, an AMI Vice President concerned with the French Hospital acquisition, wrote:

> [W]e face a choice of paying a premium price, thus controlling health care services, while meeting our earnings expectations, or continue to struggle to capture basically the same patient load with French, or another operator such as N.M.E., who may purchase French. It would be my recommendation that we proceed with the acquisition as outlined.

(CX 41C–D)

acquisition, nor was it consulted in connection with the acquisition. As a result, as was the case in *National Gerimedical Hospital*, application of the antitrust laws to AMI's acquisition would not "frustrate a particular provision of NHPRDA or create a conflict with the orders of any regulatory body." 452 U.S. at 390. Since nothing in NHPRDA required or authorized AMI to acquire French Hospital, there is no "clear repugnancy" between NHPRDA and the antitrust laws with respect to the acquisition. *Id.* at 391.

The doctrine of implied repeal is a mechanism for reconciling the antitrust laws and a subsequently enacted regulatory system. In fact, however, NHPRDA does not create a regulatory system that even applies to the acquisition at issue in this case. As the Supreme Court ruled in *National Gerimedical Hospital*, nowhere does the Act direct or authorize private conduct designed to implement HSA plans. *Id.* at 391. It is clear that the Mid-Coast HSA, like other HSAs, does not have regulatory power over hospitals or other health care providers. *Id.* at 385. Neither the HSA nor any other regulatory body possessed authority to approve or require the acquisition. As a result, as was the case in *National Gerimedical Hospital*, there can be no direct conflict between NHPRDA and the antitrust laws with respect to the acquisition, and implied immunity is not necessary to make the Act work. Since both statutory schemes can coexist without direct conflict, both will apply. At most, NHPRDA only directs HSAs "to the extent practicable" to seek to implement their plans "with the assistance of individuals and public and private entities." 42 U.S.C. 300l–2(c)(1). There is no basis in the Act for inferring a Congressional intent to immunize AMI's independent, private conduct from the antitrust laws, even if that conduct is arguably consistent with the objectives of the HSA or of NHPRDA.[33] **[183]**

The acquisition in question was a profit-motivated, unilateral, voluntary act that may incidentally have been consistent, to some extent, with Mid-Coast HSA's goals. On this slim straw AMI is now, for the purposes of this litigation, attempting to hide behind the skirts of NHPRDA. If AMI's argument is accepted, then virtually all voluntary, noncoercive behavior that arguably furthers the goals of an HSA would be exempt from the operation of the antitrust laws. Under this reasoning the rule of restricted applicability of implied repeal established by *National Gerimedical Hospital* and earlier cases would be pervasively abrogated. AMI has failed to meet the test for implied immunity from the antitrust laws set out by the Supreme Court. In addition, it is concluded that AMI's acquisition of French Hospital was not intended or reasonably calculated to advance the goals of the HSA. AMI's argument that its acts are exempt from Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act is rejected.

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[33] To the extent AMI seeks immunity from the antitrust laws based on footnote 18 in *National Gerimedical Hospital & Gerontology Center v. Blue Cross of Kansas City*, 452 U.S. 378, 393 n. 18 (1981) (*see* RB, p. 21; Resp. Reply Brief, p. 12), such reliance is misplaced. Footnote 18 suggests that the court did not intend to foreclose future claims of antitrust immunity in other factual contexts. The court indicates that immunity might be appropriate for HSAs and State agencies in the exercise of their authorized powers, and where an HSA has expressly advocated a form of cost saving cooperation among providers where it is necessary to make NHPRDA work. Here we do not have an expressly advocated form of cooperation among providers that is necessary to make NHPRDA work; instead, this proceeding concerns the unilateral, profit-motivated act of AMI in eliminating its principal competitor.

I. *The Remedy*

The Notice of Contemplated Relief served with the complaint included, but is not limited to (1) a requirement that AMI divest the assets acquired in the French Hospital acquisition, and (2) a requirement that for a period of ten years, AMI obtain prior Commission approval before making any future acquisition of any general acute care hospital located within the marketing area of a hospital owned or operated by AMI or one of its subsidiaries. In complaint counsel's post-trial brief, the prior approval provision has been limited to thirteen "sunbelt" states where AMI presently owns hospitals. Complaint counsel also would require the prior approval in the thirteen "sunbelt" **[184]** states of an acquisition where AMI leases or manages a hospital. (*See* F. 242)

AMI points out that the purpose of divestiture relief is to restore prior competition to a market; citing *Ford Motor Co. v. United States,* 405 U.S. 562, 573 (1972); *United States v. E. I. du Pont de Nemours and Co.,* 366 U.S. 316 (1961); *Retail Credit Co.,* 92 F.T.C. 1, 161 (1978), *vacated and remanded on other grounds sub. nom; Equifax, Inc. v. FTC,* 618 F.2d 63 (9th Cir. 1980). Where divestiture will not have this effect, such relief constitutes a penalty rather than a remedy and is therefore impermissible.

According to AMI, divestiture would not be appropriate in this case because it would not restore any appreciable competition that existed prior to the acquisition. Due to the prevalence of third-party hospitalization coverage in San Luis Obispo, meaningful price competition among AMI and French Hospital would not arise following divestiture. Furthermore, it is not possible to restore significant competition for physicians among hospitals in San Luis Obispo since little existed prior to the acquisition due to physician polarization in the community. In any event, this latter form of "competition" is precisely that which Congress has determined leads to duplicative equipment and excess hospital capacity. Thus, at best, divestiture would have the effect of fostering a form of business rivalry that Congress has sought to discourage because it results in costly excess and waste. (*See* RB, p. 157)

AMI also opposes any prior approval requirement on the grounds that complaint counsel has not established the prerequisites for such a remedial provision. According to AMI the record does not contain any support for a prior approval requirement that would apply to proposed acquisitions in markets other than those alleged by complaint counsel to constitute the relevant markets in this action [San Luis Obispo City and County]. There is no showing that AMI deliberately violated the antimerger laws by acquiring French, that AMI is likely to disregard the antimerger laws in the future, or that there is a "merger trend" in the industry necessitating such broad relief. The proposed prior approval requirement would unfairly handicap AMI's ability to participate in the competitive market that exists for the right to acquire hospitals that are looking for new owners. This lessening of competition is not justified by any legitimate enforcement need of the Commission. (*See* Resp. Reply Brief, p. 193)

AMI also argues that a prior approval clause would not serve any reasonable purpose since the Commission can readily monitor **[185]** AMI's acquisitions by means of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. 18a (1976). (*See* RB, 166)

It has already been concluded that AMI's acquisition of French Hospital violated the Clayton and Federal Trade Commission Acts, and that substantial actual and potential competition has been restrained and eliminated. Consequently, an appropriate remedy must be determined. It is well-settled that the Commission has wide discretion in framing an order deemed adequate to cope with the violation of law found to exist. *FTC v. Mandel Bros., Inc.*, 359 U.S. 385, 392–93 (1959); *L. G. Balfour Co. v. FTC*, 422 F.2d 1, 23 (7th Cir. 1971). In cases where a violation of Section 7 is found, the most effective remedy to correct the injury to competition is generally held to be divestiture. *Ford Motor Co. v. United States*, 405 U.S. 562, 573 (1972); *United States v. E.I. du Pont de Nemours & Co.*, 366 U.S. 316, 326–35 (1961). A ban on future acquisitions usually is ordered to prevent repeat violations. *Liggett & Meyers, Inc.*, 87 F.T.C. 1074, 1140, 1183 (1976), *aff'd*, 567 F.2d 1273 (4th Cir. 1977). As Commissioner Pertschuk recently stated in *Damon Corporation*, Dkt. C–2916, Order to Show Cause Why Order Requiring Commission Approval For Certain Acquisitions Should Not Be Modified (Dissenting Statement), March 29, 1983 [101 F.T.C. at 693]:

> Prior approval provisions, of course, have been a common fencing-in feature in decades of Commission orders. By requiring firms who have engaged in illegal mergers to get Commission approval before making future acquisitions, a prior approval provision serves both as a prophylactic measure designed to prevent future law violations by the same firm and as a deterrent to other firms which might violate the antitrust laws. As such, a prior approval provision is a modest and sensible restraint on firms that have demonstrated a propensity to violate the law.

In 1980 there were 5,830 community hospitals in the United States with a total of 988,000 beds. Seventy percent of these beds are owned by private, non-profit entities. Another 21 percent are owned by state or local government bodies. In 1972, 6.5 percent of the beds in community hospitals were controlled by for-profit entities. In 1980, that had grown to 8.8 percent. (RX 5719) That 8.8 percent includes all hospitals owned by for-profit organizations, such as doctor or other investor groups, as well as hospitals owned by for-profit multi-hospital systems such as AMI. (RX 5718, RX 5719) The five largest proprietary hospital chains, Hospital Corporation of America, Humana, AMI, National Medical Enterprises, and Lifemark **[186]** acquired a total of 192 general acute care hospitals in the years 1975–1981. (CX 608; Silvia, 794–95) During their fiscal year 1975, these firms acquired a total of three hospitals; in their fiscal year 1981, they acquired a total of 80 hospitals. To the extent that this acquisition pace cannot be termed a merger trend, the industry does appear to present conditions that are conducive to mergers.

AMI currently owns, operates or has under construction 75 hospitals in the United States. Nearly all of these hospitals were obtained through acquisition. AMI has acquired 19 general acute care hospitals since 1980. Furthermore, AMI will continue to grow by acquiring hospitals. In 1980, AMI's President stated that the objective of the company was to acquire between four and six hospitals a year, but that it might make acquisitions at a more rapid rate if the right opportunities presented themselves. (CX 430A, C, L, W) Charles P. Reilly, AMI's Senior Vice President responsible for supervising activities directed toward development of new hospitals and the acquisition of hospitals, testified that because of health planning legislation which seeks to limit the expansion of bed capacity and physical plant investment and equipment investment, there are substantially more opportunities to buy hospitals than there are to initiate and charter new ones.

Hospitals typically are owned by one of three groups: a government entity, a non-profit religious or charitable organization, or a for-profit investor group. Because of advances in hospital technology and increases in construction costs required for renovating or replacing an aging facility, establishing and operating a hospital of state-of-the-art quality is quite expensive. Local governmental agencies, religious groups or small investor groups, sometimes cannot obtain the capital necessary to provide needed health care services and therefore decide to sell the hospital. Multi-hospital systems compete to purchase these hospitals by offering financial terms and commitments to provide health services and management expertise which meet the community's needs. This competition among multi-hospital systems for acquiring hospitals is intense.

AMI contends that the prior approval order sought by complaint counsel is likely to substantially lessen competition among multi-hospital systems for acquisition of hospitals. The bidding and negotiation involved in hospital acquisitions proceed at a rapid pace and effective participation in that process requires the ability to make a firm commitment in a relatively short period. A prior approval requirement would undermine AMI's ability to put forth a firm offer in a timely fashion. This would be fundamentally different from the Hart-[**187**]Scott-Rodino filing requirement, or a requirement under state law to obtain CON approval, because such requirements are equally applicable to all purchasers. The prior approval remedy, in contrast, would apply only to AMI and would place a unique condition upon AMI's offer. Mr. Reilly also testified that a perception by hospital sellers that AMI is subject to special conditions may cause them not to contact AMI initially, even where the order does not by its terms apply, and thus AMI would not have the opportunity to compete. (Reilly, 1851)

In contrast to the testimony of AMI officials in this proceeding, AMI stated in its 1981 Form 10–K, filed with the Securities and Exchange Commission, as follows: "In the opinion of the Company's management, divestiture of French Hospital and a reasonable preacquisition screening mechanism would not have a material adverse effect on the Company's business or financial condition." (CX18M)

The divestiture of French Hospital is the most appropriate remedy to restore competition in the general acute care hospital services market in the city and county of San Luis Obispo. Further, a prior approval remedy also is appropriate. The evidence establishes that AMI in the past has grown largely through acquisitions, and because of health planning laws which limit opportunities for the development of new hospitals, AMI will continue to seek to grow through acquisitions in the future. Thus, a prior approval clause is a necessary remedial provision.

Restoring competition that has been eliminated by an illegal merger, once it is consummated, is a time-consuming and difficult process, often taking years of litigation and additional years to secure compliance with a final divestiture order. Even then, the divested entity may never regain the competitive vigor and strength that it had before being acquired. During the lengthy delay from an illegal acquisition until a successful divestiture, the public has suffered from the loss of competition. The Commission, therefore, has regularly used a prior approval clause remedy, with respect to corporations that have already made anticompetitive acquisitions, to obtain a better opportunity to prevent future anticompetitive acquistions before they take place and cause injury to the public. As the Commission stated in *Beatrice Foods Co.,* 68 F.T.C. 1003 (1965), "Prophylactic relief, not merely the after-the-fact remedy of divestiture, is essential if the Congressional policy expressed in Section 7 of the Clayton Act is to be effectively carried out. . . ." *Id.* at 1006.

Although the analysis used in merger cases has evolved over the years, the Commission consistently has utilized prior **[188]** approval as a remedial tool in merger law enforcement. Since January of last year, the Commission has issued final orders in seven merger cases,[34] and two consent agreements involving mergers have been accepted but are not yet final.[35] All nine contain prior approval relief. In three of the four, where the relevant geographic market was local or regional, prior approval is required for all horizontal acquisitions anywhere in the country.[36]

The Hart-Scott-Rodino Antitrust Improvements Act of 1976 is a reporting act, not an approval requirement. Not only may the Act's reporting requirements not reach some anticompetitive acquisitions,[37] but the Act does not prevent unlawful acquisitions. The reporting party can proceed with an acquisition unless the Commission takes affirmative legal action to prevent the acquisition, or if the acquisition is permitted to proceed, lengthy litigation is necessary to correct the violation. The fact that the Commission has continued to include prior approval clauses in merger orders is clear indication the Commission does not believe Hart-Scott-Rodino offers sufficient protection.

AMI's contention that the prior approval requirement will severely handicap it in its competition for hospitals seem overblown, as starkly revealed in its Securities and Exchange Commission filing. Because of the lengthy negotiations that **[189]** take place before a hospital is acquired (*see* RPF 16.44–16.45, 16.48), possible certificate-of-need and Hart-Scott-Rodino requirements, time is not as significant in the acquisition process as AMI posits. Further, where time is of the essence, AMI can request an early determination. The Commission has honored such requests under the Hart-Scott-Rodino Act on numerous occasions, and there is no reason to suppose the Commission would not honor AMI's request for a speedy determination under a prior approval clause.

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[34] *Gulf & Western Industries, Inc.,* Dkt. No. 9153 (FTC Apr. 14, 1983) [101 F.T.C. 707]; *ConAgra, Inc.,* Dkt. No. C–3103 (FTC Feb. 16, 1983) [101 F.T.C. 50]; *Canada Cement Lafarge Ltd.,* Dkt. No. C–3100 (FTC Dec. 21, 1982) [100 F.T.C. 563]; *Batus, Inc.,* Dkt. No. C–3099 (FTC Dec. 6, 1982) [100 F.T.C. 553]; *General Electric Co.,* Dkt. No. C–3088 (FTC May 4, 1982) [99 F.T.C. 422]; *Gifford-Hill-American, Inc.,* Dkt. No. C–3085 (FTC Feb. 23, 1982) [99 F.T.C. 372]; *Xidex Corp.,* Dkt. No. 9146 (FTC July 1, 1983) [102 F.T.C. 1].

[35] *Coca-Cola Co.,* File No. 821–0100 (FTC Apr. 26, 1983) [102 F.T.C. 1102]; *Allied Corp.,* File No. 811–0191 (FTC Dec. 8, 1982) [101 F.T.C. 721].

[36] *Canada Cement Lafarge Ltd.,* Dkt. No. C–3100 (FTC Dec. 21, 1982) [100 F.T.C. 563]; *Batus, Inc.,* Dkt. No. C–3099 (FTC Dec. 6, 1982) [100 F.T.C. 553]; *Gifford-Hill-American, Inc.,* Dkt. No. C–3085 (FTC Feb. 23, 1982) [99 F.T.C. 372].

[37] The Commission has a request for comments on a proposal to raise the Hart-Scott-Rodino threshold requirement for filing a premerger report from $15 million to $25 million. 47 FR 29181 (July 2, 1982).

Complaint counsel seeks to include in the prior approval provision of the order hospitals which AMI leases or manages. This provision appears appropriate and will be included in the Order. AMI has managed hospitals in the past, and may do so in the future. A management contract can give the management firm responsibility for running the hospital's day-to-day operations, including decisions as to staffing levels and other personnel policies, and supply and equipment purchases. In at least some cases, key hospital employees (such as the administrator, controller, and director of nursing) are employed by the management firm rather than by the hospital's owners. Even in areas for which the hospital's owners may be responsible, the management firm may make recommendations to the owners, and therefore exercise some influence over those decisions. The anticompetitive consequences of an acquisition by AMI where it already has a management arrangement in existence could create the same anticompetitive problems as if the hospital were owned outright.

Complaint counsel has proposed limiting the prior approval requirement to 13 states located in the "sunbelt" where AMI currently owns hospitals. Under complaint counsel's proposal the prior approval clause would not apply in the remaining 37 states. This is substantially less coverage than the Commission usually requires. Under a nationwide prior approval requirement, the order would become effective only *after* AMI acquires its first hospital in an area. If AMI does acquire a hospital in the remaining 37 states, then the public at that time requires the same protection as in the states where AMI now operates. While Complaint counsel has failed to offer a convincing basis for this proposed narrowing of the prior approval requirement, especially in view of past Commission precedent, I will not enlarge the relief beyond that which complaint counsel seeks.

The remaining proposals by complaint counsel to narrow the prior approval provision of the Order appear appropriate and also will be adopted. **[190]**

CONCLUSIONS OF LAW

1. The Federal Trade Commission has jurisdiction over the subject matter of this proceeding, and of respondents American Medical International, Inc. and AMISUB (French Hospital).

2. American Medical International, Inc. was, at all times relevant herein, a corporation engaged in commerce, as "commerce" is defined in the Clayton Act, as amended.

3. French Hospital Corporation was, at all times relevant herein, a corporation engaged in commerce, as "commerce" is defined in the Clayton Act, as amended.

4. French Medical Clinic, Inc. was, at all times relevant herein, a corporation engaged in commerce, as "commerce" is defined in the Clayton Act, as amended.

5. The challenged acquisition and other challenged methods of competition of respondents are in and affect commerce, as "commerce" is defined in the Federal Trade Commission Act, as amended.

6. The product market within which to evaluate the competitive effects of the challenged acquisition and the other challenged methods of competition of respondents is general acute care hospital services.

7. The geographic markets within which to evaluate the competitive effects of the challenged acquisition and the other challenged methods of competition of respondents are San Luis Obispo County, California, and the city of San Luis Obispo, California.

8. The effect of the acquisition by respondents of French Hospital Corporation, including the stock and assets acquired from Central Coast Hospital Company and the assets acquired from French Medical Clinic, Inc., has been or may be substantially to lessen competition, or to tend to create a monopoly, in the relevant product and geographic markets, in violation of Section 7 of the Clayton Act, as amended and as applicable on the date of the acquisition, July 19, 1979.

9. The effect of the acquisition of French Hospital Corporation by respondents, including the stock and assets acquired from Central Coast Hospital Company and the assets acquired from French Medical Clinic, Inc., has been or may be substantially to lessen competition, or to tend to create a monopoly, in the relevant product and geographic markets, and so constitute an unfair method of competition in or affecting commerce, in violation of Section 5 of the Federal Trade Commission Act, as amended. **[191]**

10. Respondents have attempted to monopolize the relevant product and geographic markets. This attempt to monopolize constitutes an unfair method of competition in or affecting commerce in violation of Section 5 of the Federal Trade Commission Act, as amended.

11. The Order entered hereinafter is appropriate and necessary to remedy the violations of law which have been found to exist.

ORDER

I

Definitions

It is ordered, That for purposes of this Order the following definitions shall apply:

A. *Acquire any hospital* means to directly or indirectly acquire all or any part of the stock or assets of any hospital, or enter into any arrangement by which AMI obtains ownership, management, or control of any hospital, including the right to lease or manage any hospital.

B. *AMI* means American Medical International, Inc., a corporation organized under the laws of Delaware with its principal executive offices at 414 North Camden Drive, Beverly Hills, California, and its directors, officers, agents, and employees, and its subsidiaries, divisions, affiliates, successors, and assigns.

C. *AMISUB (French Hospital)* means the wholly-owned subsidiary corporation of AMI which was established for the purpose of acquiring and operating French Hospital located in San Luis Obispo, California.

D. *County* also means a county equivalent such as a parish in Louisiana.

E. *General acute care hospital*, herein referred to as *hospital(s)*, means a health facility, **[192]** other than a federally-owned facility, having a duly organized governing body with overall administrative and professional responsibility and an organized professional staff which provides 24-hour inpatient care, and whose primary function is to provide inpatient services for medical diagnosis, treatment, and care of physically injured or sick persons with short-term or episodic health problems or infirmities.

F. *Operates a hospital* also means to own, manage or lease a general acute care hospital.

G. *SMSA* means a Standard Metropolitan Statistical Area as defined on June 19, 1981, or as may be hereafter amended, by the Office of Management and Budget, Office of Information and Regulatory Affairs.

II

It is ordered, That within twelve (12) months from the date this Order becomes final, AMI shall divest, absolutely and in good faith, all assets, properties, licenses, leases, and other rights and privileges, tangible and intangible, that AMI acquired from Central Coast Hospital Company, French Hospital Corporation and French Medical Clinic, Inc., together with any subsequent improvements. The purpose of the divestiture is to reestablish French Hospital as a viable competitor in San Luis Obispo County. The divestiture shall be subject to the prior approval of the Federal Trade Commission.

Pending divestiture, AMI shall take all measures necessary to maintain French Hospital in its present condition and to prevent any deterioration, except for normal wear and tear, of any of the assets to be divested so as not to impair French Hospital's present operating abilities or market value. **[193]**

III

It is further ordered, That for a period of ten (10) years from the date this Order becomes final, AMI shall not, without the prior approval of the Federal Trade Commission, directly or indirectly acquire any hospital located in the states of Oregon, California, Texas, Oklahoma, Missouri, Arkansas, Louisiana, Mississippi, Alabama, Georgia, Florida, South Carolina, or North Carolina, if:

A. The hospital to be acquired is within a Standard Metropolitan Statistical Area ("SMSA") in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a twenty (20) percent or more share of the licensed general acute care hospital beds within that SMSA; or

B. The hospital to be acquired is not within an SMSA but is within a county in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a twenty (20) percent or more share of the licensed hospital beds within that county; or

C. The hospital to be acquired is (1) not within an SMSA or a county in which AMI already operates a hospital, but is within thirty (30) miles of a hospital which AMI already operates in another SMSA or county, and (2) the hospital to be acquired and any hospital(s) that AMI operates combined have a twenty (20) percent or more share of the licensed hospital beds in the area within thirty (30) miles of the midpoint between the hospital to be acquired and any hospital operated by AMI.

Provided, however, That no acquisition shall be subject to this Section III if the consideration to **[194]** be paid for the hospital, including assumption by AMI of liabilities of its present owners, does not exceed one million dollars ($1,000,000).

IV

It is further ordered, That AMI shall, within sixty (60) days after the date this Order becomes final and every sixty (60) days thereafter until it has fully complied with the provisions of Section II of this Order, submit a report in writing to the Federal Trade Commission setting forth in detail the manner and form in which it intends to comply, is complying, and has complied with these provisions.

Such compliance reports shall include a summary of all contacts and negotiations with potential purchasers of the stock and assets to be divested under this Order, the identity and address of all such potential purchasers, and copies of all written communications to and from such potential purchasers.

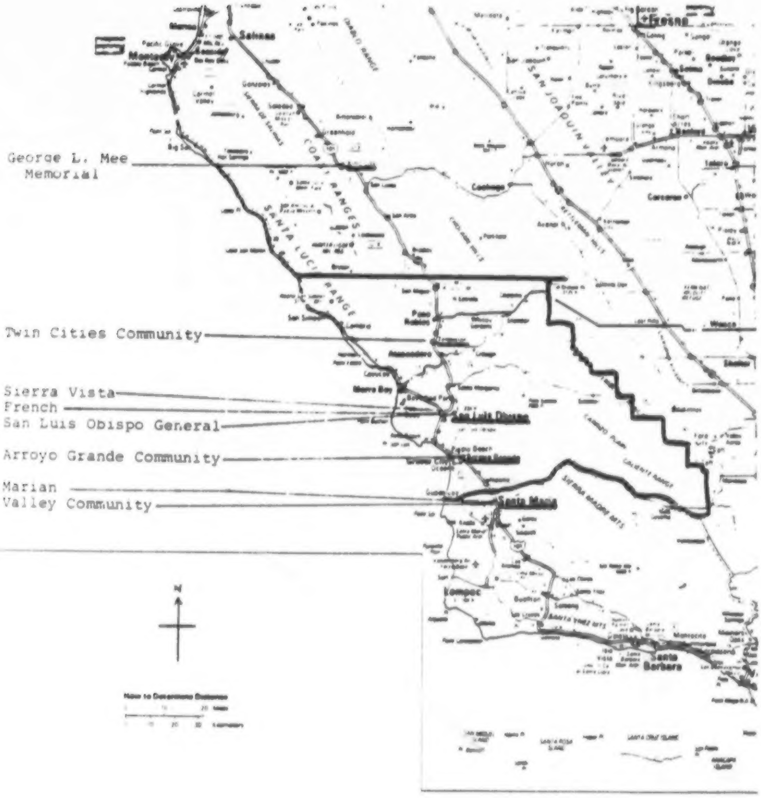
AMI also shall submit such further written reports as the staff of the Federal Trade Commission may from time to time request in writing to assure compliance with this Order.

V

It is further ordered, That AMI shall notify the Federal Trade Commission at least thirty (30) days prior to any proposed **[195]** corporate change, such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation of dissolution of subsidiaries, or any other change in the corporation which may affect compliance with the obligations arising out of this Order.

APPENDIX A

MAP OF HOSPITALS IN AND NEAR
SAN LUIS OBISPO COUNTY


George L. Mee
Memorial
Twin Cities Community
Sierra Vista
French
San Luis Obispo General
Arroyo Grande Community
Marian
Valley Community
Salinas
Monterey
Fresno
SAN JOAQUIN VALLEY
COAST RANGES
SANTA LUCIA RANGE
Coalinga
Paso Robles
Morro Bay
San Luis Obispo
Santa Maria
Lompoc
Santa Barbara
N

RX 5592

APPENDIX B

TRANSACTIONS OF AMI'S HOSPITALS IN SAN LUIS OBISPO COUNTY, 1978-1981

Payments for Hospital Services

	Medicare	Medi-Cal (Federal share only)*	Other Federal programs**	Selected private insurers***	Interstate purchases****	Total
French	$10,801,014	$1,015,309	$ 518,345	$1,149,768	$1,622,315	$15,106,751
Sierra Vista	23,683,597	1,304,242	652,947	2,445,744	3,327,346	31,413,876
Arroyo Grande	12,196,968	692,601	237,039	587,824	1,781,738	15,496,170
Total:	$46,681,579	$3,012,152	$1,408,331	$4,183,336	$6,731,399	$62,016,797

All amounts are reasonable estimates.

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* Figures for French and Sierra Vista are for period from July 1, 1977 to June 30, 1980. Figures for Arroyo Grande are for period from December 1, 1977 to November 30, 1980.

** Civilian Health and Medical Program of the Uniformed Services (CHAMPUS), Veterans Administration, and Department of Labor (Federal workmen's compensation).

*** Aetna Life & Casualty Co., the Equitable Life Assurance Society of the United States, Metropolitan Life Insurance Co., Prudential Insurance Co. of America, Republic National Life Group Insurance Co., the Travelers Insurance Companies, and Union Mutual Life Insurance Co.

**** Interstate purchases of drugs, devices, equipment, or supplies. Figure for French includes only purchases from time hospital was acquired by AMI through 1981.

Sources: CX 703; CX 729B-C; CX 734; CX 735.

APPENDIX C

Inpatient Origin by
ZIP CODES
Calendar Year 1980

	Sierra Vista		French		San Luis Obispo General		Arroyo Grande		Twin Cities		Total Admissions	
	Admissions	%	Admissions	%	Admissions	%	Admissions	%	Admissions	%	Admissions	%
San Luis Obispo Co. ZIP Codes*	6963	92.5%	3314	90.5%	4674	92.4%	2412	91.7%	3577	92.2%	20940	92.0%
No. Santa Barbara Co. ZIP Codes	256	3.4	147	4.0	133	2.6	50	1.9	—	—	586	2.6
Selected Monterey County ZIP Codes	—	—	—	—	—	—	—	—	61	1.6	61	0.3
All Other Areas	307	4.1	199	5.4	254	5.0	167	6.4	241	6.2	1168	5.1
Totals	7526	100%	3660	99.9%	5061	100%	2629	100%	3879	100%	22755	100%

Source: CX 614 through CX 618.

NOTE: Some columns may not add up to 100% due to rounding.

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* There were a number of inpatient admissions from ZIP Codes for post office boxes, government, and educational institutions in San Luis Obispo County. These inpatient admissions have been excluded from the San Luis Obispo County totals and are included in the category "All Other Areas."

APPENDIX D

HOSPITAL MARKET CONCENTRATION STATISTICS BEFORE AND AFTER FRENCH HOSPITAL ACQUISITION

	AMI Market Share				Two-firm Market Share				Herfindahl-Hirschman Index	
	Before		After		Before		After		Before	After
CITY OF SAN LUIS OBISPO	Amount	%	Amount	%	Amount	%	Amount	%		
1979 Inpatient days	45,090	57.8	68,085	87.2	68,085	87.2	78,035	100	4370	7775
1979 Hospital beds	172	44.3	310	79.9	310	79.9	388	100	3634	6788
1980 Gross inpatient revenues	$19,721,081	55.9	$30,257,621	85.8	$30,257,621	85.8	$35,273,159	100	4219	7561
1980 Gross hospital revenues	$21,956,648	53.3	$33,950,550	82.4	$33,950,550	82.4	$41,210,244	100	3996	7097
SAN LUIS OBISPO COUNTY										
1979 Inpatient days	64,524	55.6	87,519	75.5	87,519	75.5	106,004	91.4	3818	6025
1979 Hospital beds	251	45.6	389	70.6	389	70.6	473	85.8	3135	5417
1980 Gross inpatient revenues	$28,928,448	53.7	$39,473,988	73.3	$39,473,988	73.3	$48,851,618	90.7	3657	5760
1980 Gross hospital revenues	$32,877,322	52.2	$44,871,224	71.3	$44,871,224	71.3	$55,711,240	88.5	3518	5507

Note: None of the above statistics include beds, inpatient days or revenues attributable to the 14 bed psychiatric unit at SLO General Hospital, since that unit does not provide general acute-care hospital services.

The figures for 1980 gross inpatient revenue and gross hospital revenue are calculated from 1981 data contained on CX 572Z118. Each hospital's 1980 gross hospital revenue is computed by dividing its 1981 gross revenue by the sum of 100% and the "% change from prior year" for gross revenue at that hospital. A similar procedure is followed to compute each hospital's 1980 gross inpatient revenue.

Sources: CX 572Z118; CX 600; CX 601; CX 602; CX 606.

OPINION OF THE COMMISSION

BY CALVANI, *Commissioner:*

I. INTRODUCTION

Respondent American Medical International, Inc. ("AMI") appeals Administrative Law Judge Ernest G. Barnes' Initial Decision finding that AMI's acquisition in 1979 of French Hospital in the city of San Luis Obispo, California, through its wholly-owned subsidiary, AMI-SUB (French Hospital), violated Section 7 of the Clayton Act, as amended, 15 U.S.C. 18 (1976), and Section 5 of the Federal Trade Commission Act, as amended 15 U.S.C. 45 (1976).[1] Judge Barnes ordered that AMI divest the [3] acquired assets, including all subsequent improvements, and that AMI is prohibited for a period of ten years, without prior approval of the Federal Trade Commission, from acquiring general acute care hospitals in areas where it already owns or operates such a hospital.

AMI's appeal consists of six principal arguments. First, AMI argues that there is no appreciable price competition among hospitals because of the absence of price-sensitive buyers and sellers of hospital care, and that hospitals do not compete in the antitrust sense on nonprice terms, such as service and quality, because hospitals are not restrained by a functioning price mechanism. Second, AMI contends that the antitrust laws do not apply to this acquisition because of the absence of traditional competition between hospitals and because Congress, in enacting the National Health Planning and Resources Development Act, Pub. L. No. 93–641, 88 Stat. 2225 (1975), *codified at* 42 U.S.C. 300k–300s (1976), intended to immunize acquisitions such as this from antitrust scrutiny. Third, AMI maintains that the acquisition was not likely to lessen actual competition substantially in any relevant market because there was no significant pre-existing price or nonprice competition among hospitals there. Fourth, AMI asserts that recent changes in financing of health care, particularly legislation in the state of California that requires group purchasers of hospital care to negotiate with hospitals for favorable rates, may not be relied upon as a basis for retroactively applying the potential competition doctrine to this transaction. Fifth, AMI disputes Judge Barnes' finding that by acquiring French Hospital AMI attempted to monopolize the general acute care hospital services market in San Luis Obispo County and/or the City of San Luis Obispo, arguing that its intent in acquiring French Hospital was to make a profitable investment that met the goals of the local health planning agency, a legitimate business purpose, and not a specific intent to monopolize. And sixth, AMI contends that the broad prior approval remedy ordered by Judge Barnes is unwarranted because it had the reasonable, good faith belief that the antitrust laws did not apply to the transaction and because [4] it did not act in disregard of the antitrust laws. More particularly, AMI argues that there has been no showing that AMI has a "propensity to violate the law" so as to necessitate prior approval as a means of preventing unlawful transactions in the future. AMI contends that the prior approval requirement would in effect prevent it from competing for the acquisition of other hospitals. We address each of these arguments below.

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[1] Count I of the Complaint alleged that the effects of the acquisition may be to lessen competition substantially or tend to create a monopoly in the general acute care hospital market in San Luis Obispo County, California, and/or parts thereof, in the following ways:

(a) actual and potential competition among French, Arroyo Grande Community and Sierra Vista hospitals has been eliminated;

(b) concentration has been substantially increased;

(c) existing high barriers to entry have been increased and new entry into the market has been foreclosed;

(d) respondents have acquired a dominant market position; and

(e) patients, physicians, and group purchasers of hospital services, such as health maintenance organizations, may be denied the benefits of free and open competition based on price, quality, and service in choosing among hospitals.

(Complaint, ¶13) Count II of the Complaint alleged that AMI attempted to monopolize and has otherwise engaged in unfair methods of competition in this market by:

(a) acquiring French Hospital;

(b) preventing a competing national proprietary hospital chain from purchasing French Hospital and offering competition to AMI's two hospitals located in San Luis Obispo County; and

(c) authorizing its three hospitals in San Luis Obispo County to refuse to compete with each other by offering price and other concessions to Los Padres Group Health, a health maintenance organization.

(Complaint, ¶16)

We disagree with the Initial Decision in several respects. First, although we affirm liability under Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act, we do not decide whether AMI has engaged in attempted monopolization. Second, we find that the requirement that AMI obtain prior approval of the Federal Trade Commission for the acquisition of general acute care hospitals in the future eliminates AMI as a potential competitor in the hospital acquisition market to the detriment of sellers of such facilities, thereby necessitating the elimination of this requirement. Instead, we will require AMI to notify the Commission in advance of its intention to make an acquisition of the variety contemplated by Judge Barnes' order. We affirm Judge Barnes' Initial Decision in all other respects.

II. PRICE AND NONPRICE COMPETITION IN THE HEALTH CARE INDUSTRY

A. *Price Competition:*

AMI vigorously argues that because the economic incentives of physicians, hospitals, and patients are "wholly unlike those of buyers and sellers in typical markets," the hospital industry did not at the time of AMI's acquisition of French Hospital "function in anything resembling a competitive fashion." (RAB 6)[2] AMI cites to specific Congressional findings accompanying [5] passage of the National Health Planning and Resources Development Act, Pub. L. No. 93–641, 88 Stat. 2225 (1975), *codified at* 42 U.S.C. 300k–300s (1976) [hereinafter cited as the "Planning Act"], the Health Planning and Resources Development Amendments of 1979, Pub. L. 96–79, Section 103, 93 Stat. 593, *codified at* 42 U.S.C. 300k–2(b)(1), (2) (Supp. V 1981) [hereinafter cited as the "1979 Amendments"], and the Health Planning Amendments of 1983, as well as to numerous scholarly commentaries, *see, e.g.*, J. Newhouse, *The Economics of Medical Care* 63 (1978). (RAB 6–9) AMI contends that three factors prevent the hospital industry from operating in a competitive fashion: (1) nearly all hospital transactions are covered by some form of third-party payment, reducing the importance of price as a competitive variable; (2) hospitals are paid on a cost-reimbursement basis, and cost-based reimbursement removes incentives for efficiency; and (3) patients lack price information that is needed to make choices about their care and instead rely on their physician, who is no more price-sensitive than the patient. (RAB 8) AMI argues that Judge Barnes' acknowledgment of "the unique economics of health care" in his Initial Decision (RAB 10–11)[3] contradicts his conclusion that competition exists among hospitals in various "attenuated" forms that warrant protection from the antitrust laws. (RAB 11) Moreover, AMI alleges that although Complaint Counsel asserts that co-payment and deductible provisions encourage hospital selection on the basis of price, there is no evidence that any appreciable number of persons subject to such provisions in fact chose hospitals on that basis. (RAB 12)

Before determining whether price competition exists among hospitals in San Luis Obispo, we feel compelled to comment on the thrust of AMI's argument. AMI appears to be arguing that its acquisition of French Hospital should be exempt from antitrust scrutiny because there presently is no price competition in this industry and because encouraging price competition in this industry by requiring, *inter alia*, the divestiture of French Hospital, will not enhance consumer welfare. Even if we were to accept AMI's contention that price competition does not exist in this industry, which we do not, we could not accept AMI's **[6]** argument that this fact inescapably leads to the conclusion that a hospital acquisition such as the one at bar is *de facto* exempt from antitrust scrutiny. It is the role of Congress, not the Commission, to legislate exemptions from the antitrust laws, and Congress has not done so in the hospital industry. This applies equally to AMI's argument, discussed below, that the nonprice competition that exists among hospitals in the San Luis Obispo area does not constitute competition in the antitrust sense and does not merit protection of the antitrust laws.

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[2] The following abbreviations are used in this opinion:

ID - Initial Decision page number
IDF - Initial Decision finding number
Tr. - Transcript page number (designated by the name of the witness followed by the transcript page number(s))
CX - Complaint Counsel's exhibit number (followed by referenced page(s))
RX - Respondents' exhibit number (followed by referenced page(s))
RAB - Respondents' Brief on Appeal From Initial Decision
CAB - Complaint Counsel's Answering Brief
RRB - Respondents' Reply Brief on Appeal From Initial Decision

[3] AMI cites to several specific findings in this regard: that "most all transactions for hospital services are covered by third-party financing arrangements," that "under private insurance, Medicare, and Medi-Cal, neither the patient nor the physician is under pressure with respect to hospital charges," and that "patients seldom choose among hospitals based on their prices" (IDF 93); "that [c]onsumers and doctors lack an incentive to become aware of the exact prices because they know that third-party payers will pay the vast majority of the bills" (IDF 98); and that "it is the doctor who makes the basic decisions about the course of care [, and] . . . doctors do not 'price shop' for their patients" (IDF 98). *See also* IDF 33, 75, 92, 97, 105.

AMI grossly overstates the impact of industry-specific practices on the issue of price competitiveness in the health care industry. As Judge Barnes correctly concluded below, although competition in the hospital industry may not be as vigorous and intense as in other industries, competition nonetheless exists and produces salutary effects in that industry. A fair reading of the record establishes that even AMI has repeatedly acknowledged the existence of this competition in the San Luis Obispo area. For instance, one doctor complained to AMI Vice President Loftin and Mr. Carlson, the administrator of Sierra Vista Hospital:

> It is also becoming apparent that [French Hospital] is attempting to generate competition in the way of decreased surgery operating room fees, decreased hospital room fees and decreased laboratory and emergency room fees, and thus it become[s] extremely competitive with Sierra Vista Hospital.

(CX 737) This same doctor urged that AMI consider "the possibility that [a] decrease in fees [by Sierra Vista] to be competitive would be in order . . . ." (CX 737) Mr. Loftin acknowledged the competitive situation: "I share the concerns outlined in your letter," and "[w]e have been aware of the competitive moves of French Hospital and will certainly work to counteract these." (CX 738) This is credible evidence of the existence of competition that cannot be ignored. The record also documents AMI's acknowledgment that, in the abstract, competition among hospitals constrains their ability to raise rates and that, in practice, price competition between hospitals in San Luis Obispo County did constrain hospital charges. Friesen International, Inc., an AMI subsidiary, concluded that AMI's Community Hospital of Santa

Cruz was earning below normal profits because of "the two hospital competitive situation in Santa Cruz which does not permit Community to adjust rates as easily as other region hospitals." (CX 1054N; *see also* CX 1059H, 1072 W–X). Regarding an AMI proposal to build an additional hospital in Yuma, California, Mr. Victor Kolodziej, AMI Vice President and [7] Financial Director of AMI's Pacific Southwest Region, stated that such competition would constrain the rate at which hospital charges could increase:

> What we are talking about is a deescalation in the build-up of rates in the future; that what should happen within the competitive mold is that rates will not increase as they have in the past. It's not the reduction of rates themselves; it's a deescalation in the inflation of rates.

(CX 1072 W–X; *see also* CX 1030 at 2.38, 3.18). Sensing the existence of competition, AMI kept a constant eye on the more visible aspects of their charges, *e.g.*, room rates and operating room rates. (*See* CX 191 H–i; CX 38 M–N; CX 479; CX 480; Tr. Friedmann 1583). And on at least one occasion AMI responded in the classic manner to the competition that it perceived to exist, by reducing prices. French Hospital waived the fee for the use of its emergency room during "off-hours," which was intended to serve as a "patient-getting technique" for members of the French Clinic. (Tr. Friedmann 1585; Bernhardt 1249–50).

AMI makes a persuasive argument that third-party payment practices, cost-based reimbursement practices, and the relative unavailability of information needed by consumers to make decisions based on price all contribute to reduce the effect of competition in the health care industry. The impact of these factors on competition in the health care industry is well-documented. *See, e.g.*, J. Newhouse, *The Economics of Medical Care* 63 (1978). AMI also cites Congressional findings accompanying the passage of the Planning Act in 1975 and amendments thereto.[4] (RAB 6–7) Notwithstanding this, price [8] competition does exist in the health care industry, although these factors may operate to reduce its impact, and, as Judge Barnes correctly found, price competition, whether real or perceived, does exist in San Luis Obispo County to the benefit of residents of that locale. Congressional findings do not say that competition does not exist but only that the competition that does exist may be hampered by industry-specific practices such as third-party payment and cost-based reimbursement. To use the **[9]** terms employed by Congress in these findings, competition in the health care industry may be "attenuate[d]," "diminished," or "significantly reduced."[5] This is not to say that competition is non-existent or that the competition that does exist does not merit protection by the antitrust laws. Whether real or perceived, hospitals in San Luis Obispo, including AMI's Sierra Vista Hospital, sense the existence of price competition between hospitals there and, on some occasions, respond to that competition in ways that benefit consumers. This conclusion is entirely consistent with Judge Barnes' findings that hospitals engage in "some" price competition (IDF 99) and that "competition" among hospitals exists in various "attenuated" forms that warrant protection by the antitrust laws (ID at 160–61).

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[4] Thus, one report concluded:

> . . . In the view of the Committee the health care industry does not respond to classic marketplace forces. The highly technical nature of medical services together with the growth of third party reimbursement mechanisms act to *attenuate* the usual forces influencing the behavior of consumers with respect to personal health services. For the most part, the doctor makes purchasing decisions on behalf of the patient and the services are frequently reimbursed under health insurance programs, thus reducing the patient's immediate incentive to contain expenditures.

S. Rep. No. 1285, 93d Cong., 2d Sess. 39, *reprinted in* 1974 Code Cong. & Ad. News 7842 at 7878 (emphasis added). And in 1979, Congress reported:

> The Congress finds that the effect of competition on decisions of providers respecting the supply of health services and facilities is *diminished*. The primary source of the lessening of such effect is the prevailing methods of paying for health services by public and private health insurers, *particularly for inpatient health services* and other institutional health services . . . .

The Health Planning and Resources Development Amendments of 1979, Pub. L. 96–79, Section 103, 93 Stat. 593, 594–95, *codified at* 42 U.S.C. 300k–2(b)(1), (2) (Supp. V 1981) (emphasis added). The report on the Health Planning Amendments of 1983 states:

(footnote cont'd)

B. *Nonprice Competition:*

AMI mounts a two-prong attack on Complaint Counsel's claim that AMI's acquisition of French Hospital lessened nonprice competition among hospitals in San Luis Obispo County. First, AMI disputes Judge Barnes' finding that hospitals engage in competition on the basis of "nonprice considerations" (IDF 101–105, 108, 112, 127–29), and contends that conduct of this kind "is not competition in the economic sense because it is not disciplined by an effective price mechanism." (RAB 12) As proof that the hospital industry is not a "functioning market," AMI asserts that neither doctors, hospitals, nor patients balance the benefits of additional services and equipment against their costs. (RAB 12–13) Second, AMI argues that the "rivalry" that exists among hospitals cannot be equated with "competition" for purposes of antitrust analysis (RAB 16), since the "competition" that the antitrust laws is intended to encourage "is a process by which

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> One commonly cited cause of hospital overinvestment is third-party payment. Extensive coverage for hospital services by public and private insurance has created a situation in which patients and their physicians have little concern for the costs of care. The typical insurance policy pays the entire cost of hospital room and board and ancillary services. In the aggregate, only 9 percent of hospital costs were paid out-of-pocket by patients in 1980. Since hospitals encounter little resistance to increased prices, incentives to hold down costs are significantly reduced. This tends to protect hospitals from [the] penalties of excess capacity normally borne by businesses. With extensive third-party payments, *competition for patients is often based on amenities rather than price,* which in turn leads to increased investment.

H.R. Rep. No. 218, 98th Cong., 1st Sess. 3 (1983) (emphasis added; footnote omitted).

[5] *See* footnote 4, *supra* at pages 7–8.

rivalry among firms results in low prices and efficiency," and in the hospital industry "economic analysis demonstrates that the conduct in question has no such tendencies . . ." (RAB 17) AMI argues that Judge Barnes placed undue reliance on various pieces of evidence in which the term "competition" was used in a non-technical, colloquial sense, such as in what AMI labels "the Yuma documents" and "the Lewin Report."[6] (RAB 17–19)

We reject AMI's argument that the nonprice "rivalry" that exists in the hospital industry is not "competition" for antitrust purposes that warrants protection by the antitrust laws. We note as a starting point that Congress, even in the Congressional findings cited by AMI, has found that hospitals compete on nonprice dimensions. For instance, the House Committee on Energy and Commerce report on H.R. 2934, the Health **[10]** Planning Amendments of 1983, states that "[w]ith extensive third-party payments, *competition for patients* is often based on amenities rather than price, . . ." (RAB 7 (emphasis added)). This same report also noted:

> Because physicians making decisions on behalf of their patients create the demand for hospital services, *hospitals compete for patients indirectly by competing for physicians.*

(RAB 7 (emphasis added)) This is fully consistent with Complaint Counsel's claim that hospitals compete by appealing to the nonprice preferences of patients and the physicians who admit those patients. (CAB 18; *see also* ID at 183) The record clearly establishes that, contrary to AMI's assertion, economic constraints do affect hospitals' willingness to engage in nonprice competition.[7] AMI has acknowledged this on several occasions. For instance, French and AMI balanced physicians' requests for equipment against the costs associated with those requests. (Tr. Carlson 1324, Loftin 1489, Friedmann 1574–1575; *see also* IDF 146) Moreover, various factors have forced hospitals to consider costs in deciding whether to compete on the nonprice dimension by instituting new patient and physician services. Many insurance companies will not reimburse hospitals for unreasonably high charges. (Tr. Loftin 1498) This sets an upper limit on the amount that can be charged by a particular hospital. Medicare and Medicaid reimbursement systems constrain hospital spending in a similar fashion. (Tr. Derzon 1994, 1999; RX 5828; *see also* Tr. Derzon 2005) There is also evidence in the record that hospitals compete vigorously on nonprice dimensions. As a general matter, hospitals compete for physician patronage "by offering the equipment, facilities, services, amenities, and support staff that physicians want for themselves and for their patients." (Tr. Lave 826–27) Specifically, hospitals compete for physicians by maintaining high nursing levels (Tr. Boyd 374; Collins 1442; *see also* IDF 141), offering educational programs (Tr. Collins 1442; *see also* IDF 157), seeking certificate-of-need approval for new programs (Tr. Anderson 222, Lave 831), purchasing desired equipment (Tr. Lave 826, Schramm 2299), and providing favorable working conditions (CX 1030 at 3.6). Hospitals provide high quality services and offer new services in order to compete for patients (Tr. Lave 829; CX 1030 at 1.16, 1.20–1.21, 2.16–2.17, 2.47, 3.16–3.17; IDF 112), such as innovative obstetrical services and policies (Tr. [11] Lave 836–37). Friesen's study of Brookwood Medical Center, an AMI hospital, described how nonprice competition operated through adoption of the "Selective Centers of Excellence Strategy." (*See* IDF 101) AMI employed the same strategy in French and Sierra Vista hospitals—French set up a cardiac catheterization and surgery program (Tr. Anderson 221–22; IDF 156) and an advanced pediatrics program (Tr. Boyd 376; IDF 142), and Sierra Vista established a strong emergency program (*see* RX 5436Z46 & 5436Z53). These benefits resulted from increased competition between hospitals:

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[6] *See* description at pages 11–12 *infra*.

[7] AMI contends that the testimony of Complaint Counsel's economist, Dr. Lester Lave, should be dismissed "because his analysis fails to account for the absence of an effective price mechanism". (RAB 15; *see also* RAB 19-21) We reject this contention because we find above that hospitals' conduct is subject to various economic constraints.

> I think that the primary effect of nonprice competition is to keep institutions on their toes, to keep them from becoming ossified in what it is that they are doing; to try and look for new opportunities, and to try and take a look for new ways of serving physicians and patients; to keep them from simply sitting back and responding when physicians or people in the community say that they need something but instead to aggressively go out and try to find out what the market looks like, what people will want. That is very good for the whole community.

(Tr. Lave 835) There is no doubt that consumers in the health care industry benefit substantially from the nonprice competition that exists between hospitals located in San Luis Obispo County. AMI's own Lewin Report concluded:

> Competition has clearly led to increases and improvements in the services offered in these communities. Both for-profit and non-profit hospitals expanded their service offerings over the competitive periods we studied. This expansion of offerings is one of the major competitive techniques available to hospitals. Service additions both make the hospital a more desirable place for physicians to practice, and attract new patient populations.

(CX 1030 at 1.27–1.28; *see also* CX 1030 at 1.32) AMI Group Vice President Ronald Porter, arguing before a panel of the Western Arizona Health Systems Agency in support of AMI's application for approval of a new hospital in Yuma, Arizona, summarized the impact of competition in AMI's view: "Competition is good. Competition is healthy for the Yuma community." (CX 1072T) [12] AMI's view of nonprice competition is consistent with the testimony of Complaint Counsel witness Lave:

> There are always adverse effects of competition.
>
> * * * * * * *
>
> . . . [But] I think that on balance this kind of nonprice competition is extremely productive both in terms of the quality of patient care that one would see as defined by health professionals and the quality of patient care as patients would view it, which is probably just as important as the quality of care as defined by health professionals.

(Tr. Lave 839–40) Because the health care industry is disciplined by an effective price mechanism (although a price mechanism that may be less "effective" than in other industries) and the nonprice competition that does exist in the industry responds to consumers' expressions of their wants by providing services valued by physicians and patients, such as expanding the range of choices available to them, stimulating innovation, and developing expertise by hospitals, we conclude that "rivalry" among hospitals along nonprice dimensions constitutes competition in the economic sense that warrants protection by the antitrust laws.

III. IMPLIED IMMUNITY OF AMI'S ACQUISITION

AMI appeals Judge Barnes' finding that the Planning Act does not confer implied immunity from the antitrust laws on its acquisition of French Hospital. Specifically, Judge Barnes concluded that since nothing in the Planning Act required or authorized AMI to acquire French Hospital, there is no "clear repugnancy" between the Planning Act and the antitrust laws with respect to the acquisition and implied immunity is not necessary to make the Planning Act work. (ID 182)

On appeal, AMI contends that the Planning Act conflicts with the antitrust laws to the extent that it relies for its effectiveness on voluntary cooperation among providers which, though in fulfillment of Planning Act objectives, may be contrary to antitrust standards. (RAB 22) AMI argues that although Congress addressed the perceived problem of future continued overinvestment in health care resources through a "form of direct regulatory control," the certificate-of-need program, Congress explicitly rejected "a coercive regulatory approach" to address what is viewed as the problem of existing duplicative and excess services, instead adopting a program for "voluntary remedial action" by providers in response to agency recommendations. (RAB 22–23) AMI cites to various Congressional findings that stress **[13]** the importance of voluntary cooperation in the Planning Act scheme. *See* H.R. Rep. No. 1382, 93d Cong., 2d Sess. 60–61 (1974); H.R. Conf. Rep. No. 1640, 93d Cong., 2d Sess. 77, *reprinted in* 1974 U.S. Code Cong. & Ad. News 7971 at 7986; 124 Cong. Rec. 29,864 (1978) (statement of Rep. Rogers). AMI argues that since many of the voluntary activities traditionally undertaken in the health planning process would raise antitrust concerns if the antitrust laws were applied to them, there is substantial reason to conclude that Congress did not intend the antitrust laws to apply to activities undertaken by providers in response to advice from health systems agencies. (RAB 25) In support of this argument AMI points to the Supreme Court's conclusion in *National Gerimedical Hospital and Gerontology Center v. Blue Cross*, 452 U.S. 378, 392 (1981), that "the fundamental assumption of Congress, particularly in 1974 when it passed the [Planning] Act, was that competition was not a relevant consideration in the health care field." Because of this conflict, AMI contends that some sort of implied repeal is necessary in order to effectively implement the Planning Act, and that AMI's acquisition of French Hospital is precisely the type of voluntary provider action that Congress and the Supreme Court in *National Gerimedical* envisioned should be immune from antitrust attack. (RAB 27)

We must begin by noting that because implied repeal of the antitrust laws is disfavored, Congressional intent to repeal the antitrust laws "must be clear," *see, e.g., National Gerimedical Hospital and Gerontology Center v. Blue Cross*, 452 U.S. 378, 388 (1981) [hereinafter cited as *"National Gerimedical"*]. Implied immunity will be found only upon a demonstration "of clear repugnancy between the antitrust laws and the regulatory system," *United States v. National Association of Securities Dealers*, 422 U.S. 694, 719–20 (1975), and that it is "necessary to make the [conflicting statutory scheme] work," *Silver v. New York Stock Exchange*, 373 U.S. 341, 357 (1963). We find here that AMI has failed to make that demonstration.

The Supreme Court's reading of the Planning Act in *National Gerimedical* clearly demonstrates that the Planning Act does not rely for its effectiveness on voluntary cooperation among providers of the type asserted by AMI. In that case, National Gerimedical Hospital, a private acute-care community hospital in the Kansas City area, sought to enter into a participating hospital agreement with Blue Cross, a nonprofit provider of individual and group health-care reimbursement plans. Blue Cross refused on the basis of its policy barring participation by any new hospital that could not show that it was meeting a clearly evident need for health-care services in service area, relying on National Gerimedical's failure to obtain approval for its construction from the local health systems agency [hereinafter referred to as "HSA"] (because of the HSA's announced policy that it would not approve any additional acute-care beds due to existing excess capacity). Alleging a wrongful refusal to deal and a conspiracy between Blue Cross and the HSA, National **[14]** Gerimedical filed suit against Blue Cross under Sections 1 and 2 of the Sherman Act. Blue Cross contended that the Planning Act of 1974 impliedly repealed the antitrust laws as applied to the conduct in question. The Supreme Court reversed the trial court's decision to grant Blue Cross summary judgment, finding that although the purpose of the Planning Act was to prevent overinvestment in and maldistribution of health care facilities,

> The action challenged here was neither compelled nor approved by any governmental, regulatory body. Instead, it was a spontaneous response to the finding of an advisory planning body, the local HSA, that there was a surplus of acute-care hospital beds in the Kansas City area. . . .
>
> . . . It cannot be argued that application of the antitrust laws to the conduct of Blue Cross would frustrate a particular provision of the [Planning Act] or create a conflict with the orders of any regulatory body. The record discloses no formal request from [the local HSA] to Blue Cross to refrain from accepting [National Gerimedical] as a new participating hospital.

452 U.S. at 389–90. As does AMI in this case, Blue Cross relied on the fact that a major function of an HSA was to eliminate unnecessary duplication of hospital services, pointing to statutory language in the Planning Act requiring each HSA to "seek, to the extent practicable, to implement its [health plans] with the assistance of individuals and public and private entities in its health service area." The Supreme Court rejected this:

> . . . Here, [Blue Cross] argue[s], the HSA found that [National Gerimedical] was duplicating hospital facilities unnecessarily, and Blue Cross merely sought to aid in the "implementation" of that finding.
>
> We are unpersuaded, however, that the provisions cited by Blue Cross are sufficient to create a "clear repugnancy" between the [Planning Act] and the antitrust laws, at least on the facts of this case. . . . Nothing in the [Planning Act] requires Blue Cross to **[15]** take an action that, in essence, sought to enforce the advisory decision of [the local HSA]. . . .

Id. at 391.

Admittedly, the Planning Act does rely to some degree upon voluntary cooperation of health care providers. Thus, AMI's contention that the Congressional solution to the maldistribution of existing costly health services depends for its effectiveness on the willingness of providers to voluntarily conform their activities to HSA plans and goals is not incorrect. Nor is AMI's conclusion that Congress rejected a coercive regulatory system to battle this problem. The fact that Congress did not give HSA's any formal power to enforce their recommendations, as the Supreme Court implied in *National Gerimedical*, 452 U.S. at 385, is consistent with this. However, it is clear from the Supreme Court's reading of the Planning Act in *National Gerimedical* that Congress' reliance on voluntary cooperation by providers to implement that Act envisions something more than a provider's unilateral response to a general statement of policy announced by the local HSA, as was the case in AMI's acquisition of French Hospital. In *National Gerimedical*, the local HSA announced its policy not to approve any additional acute-care beds due to existing excess capacity. The Court noted the absence of a "formal request from [the local HSA] to Blue Cross to refrain from accepting [National Gerimedical] as a new participating hospital," 452 U.S. 390, and presumably this "request" would be a prerequisite to a finding of implied immunity in that case. The fact that the Court would require that the local HSA "request" that the health care provider act in some specific manner is consistent with the voluntary framework that Congress envisioned, as is the requirement that "[t]he action challenged here . . . [be] approved . . ." by the local HSA, *National Gerimedical*, 452 U.S. at 389, "approval" in terms of "state agency review, comment and recommendation to providers." We need not address whether the type of voluntary cooperation by providers that the Planning Act envisions is in conflict with the antitrust laws, necessitating an implied repeal of antitrust liability. Instead, we find that AMI's acquisition of French Hospital is not the type of voluntary conduct that is envisioned by the Planning Act.

The Planning Act envisions voluntary actions by health care providers in response to specific recommendations contained in the Annual Implementation Plan [hereinafter referred to as "AIP"] that is adopted by the local HSA. Specifically, the Planning Act requires HSA's to "develop and publish specific plans and projects for achieving the objectives established in the AIP." 42 U.S.C. 3001-1(b) (4) (1976). To the extent that an HSA recommends an action with this specificity, or as the Supreme Court stated in *National Gerimedical*, "[w]here, for example, an HSA has *expressly* advocated a form of cost-saving cooperation among providers, . . .," 452 U.S. at 393 n.18 (emphasis added), . . ." implied immunity *may* be deemed appropriate. The requisite **[16]** specificity is absent in this case. The Mid-Coast HSA [hereinafter referred to as "MCHSA"] did not expressly direct AMI to acquire French Hospital. AMI's only "official" directive for the acquisition is general statements favoring consolidation that appeared in the Health Systems Plan [hereinafter referred to as "HSP"] and AIP. As Judge Barnes correctly found, the MCHSA predicted in the 1979–1984 and 1978–1983 HSP's that excess beds would exist in the future. The 1978–1983 HSP recommended the establishment of a task force to prepare a report with specific recommendations for "consolidation of services and/or delincensure of beds." (RX 5466Z181–Z182, Z265–Z266) The report was to serve as the basis for a "preliminary strategy for reallocation, consolidation or delicensure" of hospital beds in the HSA's area, with the feasibility of consolidation to be examined "in specified service[s]." (RX 5466 Z183–Z184, Z266–Z268; RX 5461Z1–Z2) Although this task force was organized, the record is unclear as to whether any such report was, in fact, prepared. (Tr. Bernhardt 1296) Also, although the 1979–1980 AIP noted that low occupancy at area hospitals would improve "through the [MCHSA's] stated policy to encourage conversion of excess beds to services with shortages, *as well as mergers*" (RX 5461Z63 (emphasis added)), a member of the MCHSA was unable to recall any specific discussions as to what was meant by the term "merger" (Tr. Bernhardt 1293–94) and the MCH5A did not contemplate consolidation of particular facilities in writing its plans (Tr. Bernhardt 1273–74). In short, the record amply supports the conclusion that nothing in the MCHSA's HSP, AIP, or any policy statement promulgated pursuant to the Planning Act contemplated AMI's acquisition of French Hospital. Thus, absent specific prompting by the operation of the Planning Act mechanism, AMI's acquisition of French Hospital cannot be considered to be even eligible for implied immunity from the antitrust laws.

AMI's claim that Judge Barnes misread both the Planning Act and *National Gerimedical* is misdirected. First, AMI argues that Congress' rejection of a system of mandatory regulation in favor of voluntary provider cooperation is contrary to what AMI characterizes as Judge Barnes' assumption that an exemption can be found only if the industry is subject to a "traditional, coercive regulatory system." (RAB 30) The Initial Decision makes no reference to "coercive" regulation, in the sense of being subject to the full enforcement power of the law; rather, it is couched in terms of "approval" or "review." This is consistent with the Supreme Court's finding in *National Gerimedical* that "Congress expected HSA planning to be implemented mainly through persuasion and cooperation," 452 U.S. at 391. Second, AMI argues that the Court in *National Gerimedical* does not require specific authorization by a regulatory body or advance review of provider plans by local HSA's. To the contrary, the Planning Act does imply the need to secure HSA approval to the extent that it permits individual providers to identify specific conduct that the HSA, through community input, deems to be in furtherance of Planning Act goals, not some unilateral conduct that is untested by community [17] interest. The Court's decision in *National Gerimedical* rested on a finding that Blue Cross' refusal to deal "was neither compelled nor approved by any governmental, regulatory body," 452 U.S. at 389. This certainly suggests that approval by a regulatory body (*i.e.*, in the sense that the private conduct is weighed against a public interest standard) is a prerequisite to eligibility for implied immunity.

IV. EFFECT OF THE ACQUISITION ON COMPETITION

A. *Relevant Product and Geographic Markets*

Having found that AMI's acquisition of French Hospital is subject to antitrust scrutiny under Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act, we now turn to a consideration of the competitive effects of the acquisition. Section 7 of the Clayton Act (as amended by the Antitrust Procedural Improvements Act of 1980, Pub. L. 96–349, Section 6(a), 94 Stat. 1157) provides, in pertinent part:

> No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, *where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.*

15 U.S.C. 18 (emphasis added). *See Atlantic Richfield Refining Co. v. FTC,* 344 F.2d 599 (6th Cir.), *cert. denied,* 382 U.S. 939 (1965), (Federal Trade Commission Act construed *in pari materia* with Clayton Act). Section 7 specifies two separate statutory standards under which AMI's acquisition of French Hospital may be held unlawful—if its effect: (1) "may be substantially to lessen competition," or (2) "to tend to create a monopoly." *See, e.g., United States v. Pennzoil Co.,* 252 F.Supp. 962 (W.D. Pa. 1965). Both the legislative history surrounding the passage of Section 7 and the case law demonstrate that Section 7 applies to "incipient" violations and that there is no need to prove that the merger would have any actual or definite anticompetitive effects. *See, e.g., FTC v. Proctor & Gamble Co.,* 386 U.S. 568, 577 (1967); *A. G. Spalding & Bros., Inc. v. FTC,* 301 F.2d 585 (3d Cir. 1962). Consequently, if it is *reasonably probable* that the merger would substantially lessen competition or tend to create a monopoly, the merger will be held to be unlawful under Section [18] 7. *See, e.g., United States v. Ingersoll-Rand Co.,* 320 F.2d 509 (3d Cir. 1963). Before determining whether any probable anticompetitive effect is likely to result from

the proposed merger, the "line of commerce" and "section of the country," *i.e.,* the relevant product and geographic markets, must first be determined. Only after delineating these markets can the anticompetitive impact of the merger be measured.

A "line of commerce" is a product, service, or market in which one or both of the merging companies compete. *See United States v. Pennzoil Co.,* 252 F.Supp. 962 (W.D. Pa. 1965). Prior to 1962, three different tests had been used in determining the relevant market in Section 7 cases—"reasonable interchangeability of use," "cross-elasticity of demand," and "particular characteristics and uses," *United States v. E. I. du Pont de Nemours & Co.,* 353 U.S. 586 (1957). *Accord, Reynolds Metals Co. v. FTC,* 309 F.2d 223, 226 (D.C. Cir. 1962). But in *Brown Shoe Co. v. United States,* 370 U.S. 294, 325 (1974) the Supreme Court summarized the controlling test as follows: "[t]he outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it." 370 U.S. 294, 325 (1962) (footnotes omitted).[8] *See Grand Union Co.,* Dkt. No. 9121, slip op. at 15 (July 18, 1983) [102 F.T.C. at 1041]. *See also United States v. Continental Can Co.,* 378 U.S. 441 (1964). The relevant market is determined by examining several factors, not all of which need exist in a Section 7 case: "industry or public recognition of the [market] as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors." 370 U.S. at 325. *Accord, Elco Corp. v. Microdot, Inc.,* 360 F.Supp. 741 (D.Del.1973) (metal plate connectors as a relevant submarket of the backpanel connector assembles market). The Commission Merger Statement and Justice Guidelines employ related criteria in defining the relevant product market. *See* Statement of Federal Trade Commission Concerning Horizontal Mergers, *reprinted in* CCH Trade Reg. Rep. (No. 546, June 16, 1982) [hereinafter referred to as "Commission Statement"]; U.S. Department of Justice Merger Guidelines, *reprinted in* CCH Trade Reg. Rep. ¶4500 (No. 655 (Part [**19**] 2), June 18, 1984) [hereinafter referred to as "Justice Guidelines"]. According to the Commission Statement:

> The purpose of product market analysis is to ascertain what grouping of products or services should be included in a single relevant market. Where the cross-elasticity of demand for separate products or services is high, they normally will be within the same product market. Similarly, a high cross-elasticity of supply tends to suggest the existence of a common product market. Therefore, the issue of whether related products

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[8] If two products are "reasonably interchangeable" (in that they can be used for the same purposes), permitting consumers to switch from one to another, they are within the same product market. *Accord, United States v. E. I. du Pont de Nemours, & Co.,* 351 U.S. 377 (1956) (Sherman Act Section 2 context). Products demonstrating positive demand cross-elasticity, *i.e.,* a decrease in the price of one product causes consumers of a similar second product to switch to the first product, likewise compete in the same product market. *Id.*

> or services place a significant constraint on the ability of merging firms to raise prices, limit supply or lower quality, is central to evaluating the competitive effects of a horizontal merger.

Commission Statement at 84.

Turning to the specific facts presented in this case, Judge Barnes found general acute care hospital services to be the appropriate product market in which to evaluate the competitive effects of AMI's acquisition of French Hospital. AMI advances several related arguments in its appeal of this finding. AMI argues that the process of defining relevant markets in the health care industry is an artificial exercise because it is necessarily based on the effects of price changes, and buyers and sellers in this industry are not price-sensitive. Instead, AMI urges that the product market be defined in terms of reasonable substitutability. AMI contends that Judge Barnes violated this standard by excluding non-hospital providers of the individual services that comprised the "cluster of services" provided by general acute care hospitals that Judge Barnes found to constitute the relevant product market. AMI points to numerous outpatient substitutes for hospital care in San Luis Obispo, such as clinics, physicians' offices, and medical laboratories, which AMI argues are "completely interchangeable with the outpatient services provided in hospitals" and therefore should be included in the product market definition. (RAB 39)

We begin by noting that the courts and this Commission have found it appropriate to adopt a "cluster of services" as the relevant product market on several earlier occasions. *See generally Grand Union Co.*, Dkt. No. 9121, slip op. at 19 (July 18, 1983) [102 F.T.C. at 1044]. For instance, the district court in *United States v. Philadelphia National Bank*, 201 F.Supp. 348 (E.D. Pa. 1962) [hereinafter cited as *"Philadelphia National Bank"*], faced a similar situation where defendants urged the inclusion of all suppliers of the individual products and services that comprised the "cluster of services" known as commercial banking. The court [20] concluded that that cluster of services "viewed collectively, has efficient peculiar characteristics which negate reasonable interchangeability," 201 F.Supp. at 363, which the Supreme Court affirmed on appeal, 374 U.S. 321, 355–57 (1963). *See also United States v. Connecticut National Bank*, 418 U.S. 656, 664–66 (1974); *United States v. Phillipsburg National Bank & Trust Co.*, 399 U.S. 350, 359–62 (1970). In other instances, the courts have examined a variety of factors to determine the proper content of the "cluster" market definition, such as "the functional complementarity and integration linking the products," the "degree of commonality in the technology and manufacturing processees involving the components of the market," whether "all products are marketed through similar channels and to the same group of buyers" and whether "this market has recognition in the industry," *United States v. Hughes Tool Co.*, 415 F.Supp. 637 (C.D. Cal. 1976) (oil pipe handling products), "whether there are competitive relationships between the lines of commerce warranting them to be aggregated as a group for the purpose of measuring the impact of the merger on competition," *A. G. Spalding & Bros. v. FTC*, 301 F.2d 585, 603–04 (3d Cir. 1962), *aff'g* 56 F.T.C. 1125, 1160 (1960) (gymnastic equipment), or "where, for technological or other reasons, there is commonality in production and distribution resulting in a distinct and recognized 'industry' of firms who sell a broad line of such products," *British Oxygen Co.*, 86 F.T.C. 1241, 1345 (1975), *rev'd on other grounds sub nom. BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977) (industrial gases). *See also* cases cited in 16B Business Organizations, Von Kalinowski, *Antitrust Laws and Trade Regulation* ¶18.02[3] at 18–83 *et seq.* (1983). Thus, it appears that product market definitions consisting of a "cluster" of products or services is well-established in the case law.

Judge Barnes recited a long list of factors that he felt mandated a finding that the cluster of general acute care hospital services constituted the relevant product market in this case. (*See* ID 129–31) These factors included the uniqueness of the cluster services made available by general acute care hospitals (for instance, California law requires that medical, nursing, surgical, anesthesia, laboratory, radiology, pharmacy, and dietary services be offered on a 24-hours basis); unique services or equipment provided by general acute care hospitals (for instance, there are no free standing surgical or emergency room facilities in the area); and the complementarity of the individual services that are provided by general acute care hospitals. Judge Barnes also noted that the cross-elasticity of supply for hospital services is low (due to existing legal requirements imposed on market entry) and that general acute care hospitals are recognized by government agencies, state law, and industry participants as a distinct class of health care provider (to the exclusion of outpatient facilities).

Based on our review of the record, we conclude that AMI's attack on Judge Barnes' product market definition is [21] misdirected. In *Philadelphia National Bank*, 201 F.Supp. 348 (E.D. Pa. 1962), the district court noted that

> With the possible exception of [one individual service], there is an identical or effective substitute for each one of the services which a commercial bank offers. From this the Court is to conclude that because the services offered by other financial institutions are reasonably interchangeable with those offered by commerical banks, the separate lines of commerce suggested by the plaintiff cannot be limited merely to commercial banks,

> but must include in each and every case the services of other financial institutions as well.

201 F.Supp. at 361–62. AMI argues the same position here. In *Philadelphia National Bank,* the court concluded that it was the complementarity of these individual services, taken together, that made them a unique product or service cluster:

> It is the conglomeration of all the various services and functions that sets the commercial bank off from other financial institutions. Each item is an integral part of the whole, almost every one of which is dependent upon and would not exist but for the other . . . Nevertheless, the Court feels quite confident in holding that commercial banking, viewed collectively, has sufficient peculiar characteristics which negate reasonable interchangeability.

Id. at 363. A similar result must obtain in this case. Although each individual service that comprises the cluster of general acute care hospital services may well have outpatient substitutes, the benefit that accrues to patient and physician is derived from their complementarity. There is no readily available substitute supplier of the benefit that this complementarity confers on patient and physician. This is consistent with record evidence that shows that those in the market only recognized other hospitals, not suppliers of individual hospital services, as their competitors. (*See* ID 131)

"Section of the country," as that language appears in Section 7, refers to the geographic area of effective competition between the two companies in which the relevant product is traded. *Accord, United States v. Marine Bancorporation, Inc.,* 418 U.S. 602, 620–22 (1974). Despite some doubt cast by the Supreme Court's opinion in *United States v. Pabst Brewing Co.,* 384 U.S. 546 (1966), proof of the relevant geographic market—**[22]** the "section of the country"—is an essential element in a Section 7 case, "'a necessary predicate' to deciding whether a merger contravenes the Clayton Act," *United States v. Marine Bancorporation,* 418 U.S. at 618.

The Supreme Court in *Brown Shoe* summarized the controlling criteria for determining the relevant geographic market:

> Congress prescribed a pragmatic factual approach to the definition of the relevant market and not a formal, legalistic one. The geographic market selected must, therefore, both "correspond to the commercial realities" of the industry and be economically significant. Thus, although the geographic market in some instances may encompass the entire nation, under other circumstances it may be as small as a single metropolitan area.

370 U.S. at 336–37. *Cf. United States v. Kimberly-Clark Corp.,* 264 F.Supp. 439 (N.D. Cal. 1967) (same criteria used in vertical and hori-

zontal merger cases to determine relevant geographic market). In practice, the courts have read *Brown Shoe* by giving particular emphasis to several somewhat overlapping economic factors in determining relevant geographic markets: (1) competitive price disadvantages resulting from high transportation costs, *see, e.g., Luria Bros. & Co. v. FTC,* 389 F.2d 847 (3d Cir. 1968); (2) availability of alternative suppliers, *see, e.g., United States v. Pennzoil Co.,* 252 F.Supp. 962 (W.D. Pa. 1965); and (3) industry recognition of the market as a separate and distinct market, *see, e.g., United States v. Federal Co.,* 1975–2 Trade Cas. (CCH) ¶60,397 (W.D. Tn. 1975).

Both the Commission Statement and Justice Guidelines focus on the impact of a price change within different geographic areas in defining the relevant geographic market. *See Grand Union Co.,* Dkt. No. 9121, slip op. at 23 (July 18, 1983) [102 F.T.C. at 1047]. Under the Commission Statement, "an area is a separate geographic market if a change in the price of the product in that area does not, within a relevant period of time, induce substantial changes in the quantity of the product sold in other areas." Commission Statement at 13. The geographic market is defined under the Justice Guidelines in a similar fashion.

Judge Barnes concluded that the geographic markets within which to evaluate the competitive effects of AMI's acquisition are San Luis Obispo County and the City of San Luis Obispo. AMI disputes these, arguing that a large number of San Luis Obispo County residents travel outside county boundaries for hospital care and that the three hospitals located within the city of San Luis Obispo rely heavily upon out-of-city residents to occupy their hospital beds. However, AMI does concede that "the **[23]** relevant considerations [for purposes of geographic market definition] are where patients actually go for care and where they may practicably turn for it." (RAB 40) *See generally Tampa Electric Company v. Nashville Coal Co.,* 365 U.S. 320, 327 (1961).

In defining the geographic markets as he did, Judge Barnes relied in large part on patient flow statistics provided by Complaint Counsel. These patient flow statistics consist of two parts: patient "in flow" into county hospitals, and patient "outmigration" to hospitals located outside the county. The "in flow" statistics showed that over 90% of persons hospitalized in the five county hospitals were residents of San Luis Obispo County. (ID 134) Although the outmigration statistics were less certain, evidence showed that the incidence of outmigration ranged from as low as 5% (estimated by MCHSA) to as much as 14.5% of county residents (estimated for Medicare purposes). (ID 134–35) Assuming that county residents utilize hospitals at the same rate as residents of California in general (instead of employing the MCHSA utilization rate), AMI estimated patient outmigration to be as high as 30% of the county residents. (ID 135) In support of his narrower geographic market definition, the City of San Luis Obispo, Judge Barnes concluded from an examination of patient flow statistics that residents of the city and environs go almost exclusively to hospitals located within the city. (ID 137)

AMI does not set forth any plausible basis on which we can even consider reversing Judge Barnes' geographic market definitions. AMI does not attack Judge Barnes' reliance on patient flow statistics for purposes of defining the relevant geographic markets ("the relevant considerations are where patients actually go for care and where they may practicably turn for it" (RAB 40)), but instead challenges his patient in flow and outmigration findings. Specifically, AMI alleges that the correct county outmigration figure is "a minimum of about fifteen percent" and that "the true figure may be close to thirty percent;" and that excluding out-of-city residents as patients, "French would have an occupancy rate of approximately 19.7 percent, [San Luis Obispo General Hospital] about 18.7 percent, and Sierra Vista about 34.8 percent." (RAB 40) AMI apparently does *not* dispute Judge Barnes' other very detailed conclusions supporting the county and city market definitions, such as geographic barriers (patient convenience and limited mobility, location of admitting physician) and industry recognition of these markets (as evidenced by AMI planning documents and testimony of hospital administrators).

With regard to AMI's patient outmigration estimates, the study prepared by AMI witness Mittelstaedt specifically for purposes of this litigation is clearly outweighed by other more probative evidence, including Medicare and Medi-Cal estimates, OSHPD estimates, and estimates prepared by AMI's own Friesen prior to this litigation. Correcting the patient utilization rates used by Mittelstaedt to reflect San Luis Obispo residents' **[24]** lower-than-average utilization, Mittelstaedt's study appears to be in line with Friesen's earlier estimate and the 5% to 14% range found by Judge Barnes. With regard to AMI's patient in flow statistics, although it does appear that the three hospitals in the city do draw a substantial number of patients from sections of the county outside of the city boundaries, AMI's argument ignores practical "commercial realities" that affect competition in the market for inpatient hospital services. First, French and Sierra Vista hospitals appear to be superior (in terms of facilities, size, and equipment) to hospitals outside the city limits and, consequently, it is not surprising that patients from outlying areas travel to the city for services not available locally. Thus, with regard to a number of service offerings (*e.g.*, CAT scan, cardiac catheterization, open heart surgery, obstetrics), out-of-city hospitals simply do not compete with hospitals located inside the city limits. Second, as we concluded earlier, hospitals engage in very vigorous competition for physicians on nonprice dimensions because, as a general matter, it is the physician who is responsible for admitting patients to hospitals, and hospitals compete for physicians in order to increase admissions. On the basis of our review of the record, it appears that physicians generally admit patients where it is most convenient for the admitting physician (Tr. Bernhardt 1237); that distance and travel time make it difficult for physicians to use hospitals that are not located near their offices (Tr. Boyd 340, Harvey 1682); and that the overwhelming number of patient admissions to French, Sierra Vista, and San Luis Obispo General (approximately 98%) are by physicians located within the city or its immediate vicinity (*see* CX 622–24). Thus, whatever the reason for the high density of hospitals and physicians within the city limits,[9] competition for patient admissions by French and Sierra Vista appears to focus inside the city limits. Third, participants in the hospital services market in which French and Sierra Vista operate view the city and its immediate environs as a separate geographic market. The former administrator of French Hospital (now administrator at Twin Cities) testified that, as administrator at French, he did not view Twin Cities or Arroyo Grande as competition because they were too far away and had "a distinct medical staff and community" (Tr. Anderson 227); that he "regarded principally Sierra Vista Hospital as our competition" for physicians and patients (Tr. Anderson 228); and that as administrator at Twin Cities he does not attempt to attract patients from the city of San Luis Obispo because "[i]t is unreasonable to expect patients to commute 25 miles to come to Twin Cities Hospital" (Tr. Anderson 239). Internal AMI documents corroborate a finding that the City of San Luis Obispo comprises a separate geographic **[25]** market. In conjunction with AMI's request to approve the addition of 39 beds for Arroyo Grande Hospital in the early 1970's, AMI's administrator urged health planning authorities to segregate the county into three distinct service areas, "one being the north part of the county, one the central part of the county, encompassing [the City of] San Luis Obispo[,] and the third area is the south portion of the county . . ." (CX 188), with which recommendation the health planning authorities concurred (CX 217Z11–Z12). Similarly, a long-range planning study prepared by the staff of AMI Vice President Loftin supports the division of San Luis Obispo County into competitively-separate markets:

> It is important to reiterate that our findings clearly pointed to the fact there is no definable competition for Arroyo Grande Community Hospital. The hospitals south of

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[9] AMI's claim that "[t]he ALJ was confused by the fact that both hospitals and doctors congregate in easily accessible population centers" (RAB 40) is without record support and simply makes no sense whatsoever.

> Arroyo Grande are geographically located too far away to be competition and the facilities, Sierra Vista and French and County, in the north likewise are geographically too far away to be considered direct competition . . . .

(CX 197N) AMI's claim in its Appeal Brief that "[t]his peculiar analysis leads to the conclusion that every hospital with medical office buildings nearby, such as French Hospital before the acquisition, is a monopolist" (RAB 40) is a meaningless overstatement of Judge Barnes' findings. Before AMI's acquisition, French Hospital engaged in price and nonprice competition with Sierra Vista Hospital and, to a lesser extent, San Luis Obispo General Hospital, for physicians and patient admissions. We conclude that the geographic dimension of this competition is a relevant market for purposes of analysis under the antitrust laws.

B. *Market Power in the Health Care Industry*

Before proceeding with a consideration of the effects of AMI's acquisition of French Hospital on the general acute care health services markets in San Luis Obispo County and the City of San Luis Obispo, we are compelled to address AMI's contention that Judge Barnes erred in relying on indices based on market shares in determining the competitive effects of the acquisition. AMI argues that the traditional presumption that a substantial increase in market concentration or in a firm's market share results in a lessening of competition, as enunciated by the Supreme Court in *United States v. Philadelphia National Bank,* 374 U.S. 321, 363 (1963), is not applicable in the health care industry because the economic assumptions on which this presumption is based (which AMI argues are present in "manufacturing and related industries") are not present in this industry. (RAB 41) Specifically, AMI contends that since the **[26]** economic basis for the market share presumption is the notion of market power, and the concept of market power is premised on the existence of a competitive price and price-sensitive buyers and sellers, increased market shares do not necessarily enhance market power in the health care industry where price-sensitivity on behalf of buyers and sellers is absent. For instance, AMI argues that due to the third-party payment mechanism, which is governed by regulatory and contractual payment provisions, a "sole provider" hospital cannot exercise the market power that it ostensibly possesses to exact charges in excess of what it could get in a more competitive market. (RAB 43)

AMI's argument is nothing more than a resynthesis of its earlier argument that price and nonprice competition does not take place in the hospital industry. AMI's basic assumption is that price constraints are not present in this market. To the contrary, as we concluded earlier,[10] the record clearly demonstrates that price constraints influence the decisions made by both buyers and sellers in the health care industry, creating price and nonprice competition among hospitals that occupy overlapping service territories for increased patient admissions. Second, AMI's argument that market share evidence is valuable only in cases involving "manufacturing and related industries in which normal market forces can reasonably be assumed to operate" (RAB 41) is contrary to both common sense and case law precedent. For example, the courts have employed traditional market share criteria in numerous "non-manufacturing" contexts, such as commercial banking services, *see, e.g., United States v. Philadelphia National Bank,* 374 U.S. 321, 363 (1963), in-patient psychiatric care by private psychiatric hospitals, *see, e.g., United States v. Hospital Affiliates Int'l, Inc.,* 1980–81 Trade Cas. (CCH) ¶63,721, at 77,853 (E.D. La. 1980), and acute care community hospital services, *see American Medicorp, Inc. v. Humana, Inc.,* 445 F.Supp. 589 (E.D. Pa. 1977), to name only a few.

C. *Competitive Effects of the Acquisition: Price and Nonprice Dimensions*

We now turn to the ultimate question concerning the merits of Complaint Counsel's Section 7 case, whether the effect of the acquisition will be to substantially lessen competition or tend to create a monopoly in the relevant markets. However, before doing so, we note that Section 7 does not prescribe any particular methodology for determining this. In *Brown Shoe,* the Supreme Court refused to extend application of the "quantitative substantiality" doctrine (which developed in the context of Section 3 of the Clayton Act) to Section 7 cases, instead requiring that each case be "functionally viewed" in the context of its particular industry, 370 U.S. at 321–22. The Court **[27]** concluded that an acquisition should not be judged solely on the basis of market share statistics, but by considering both qualitative factors —the market's "structure, history, and probable future"—and quantitative factors. *Id.* at 322 n.38. *See Grand Union Co.,* Dkt. No. 9121, slip op. (July 18, 1983) [102 F.T.C. at 1032]. Despite the reemergence of a mechanistic quantitative approach in several subsequent Supreme Court cases, *see, e.g., United States v. Pabst Brewing Co.,* 384 U.S. 546 (1966); *United States v. Von's Grocery Co.,* 384 U.S. 270 (1966), in which the Court gave almost conclusive weight to the relative market shares of the merger partners, two recent cases signal the Court's retreat back to the *Brown Shoe* qualitative market structure analysis, *see United States v. Marine Bancorporation, Inc.,* 418 U.S. 602 (1974); *United States v. General Dynamics Corp.,* 415 U.S. 486

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[10] *See* discussion at pages 4–9 *supra.*

(1974). Consequently, although market share evidence is an important starting point in merger analysis, it alone is not conclusive in determining the legality of a merger under Section 7.

Both the Justice Guidelines and Commission Statement reflect the importance of considering both quantitative and qualitative elements of the acquisition. Although the Commission has expressed an intent to give "considerable weight" to the Justice Guidelines, it has not endorsed either the analytical approach or the numerical thresholds and tests for analyzing mergers contained in the Justice Guidelines. *See* Announcement of Policy: Federal Trade Commission Announces Horizontal Merger - Enforcement Policy, *reprinted in* CCH Trade Reg. Rep. (No. 546), June 16, 1982, at pp. 86–87. More importantly, the Commission emphasizes certain "qualitative" factors over strict "quantitative" industry concentration measures. "Market wide" conditions that may merit consideration include entry barriers and shifts in product demand:

> The issue of entry barriers is perhaps the most important qualitative factor, for if entry barriers are very low it is unlikely that market power, whether individually or collectively exercised, will persist for long. Conversely, if entry barriers are quite high, the effect may be to exacerbate any market power conferred by the merger . . . .
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> Market power also may be harder to exercise or less likely to endure in the face of rapid technological change or significant upward shifts in demand. Moreover, this kind of evidence may shed light on questions of market definition and the market's propensity for collusive interdependence . . . . Market share fluctuations may represent overt [28] manifestations of underlying market forces and, as such, provide a very useful picture of market dynamics. Of course, like other evidence, the value of such data depends upon the magnitude and likely duration of the shifts that are occurring. Small deviations in market shares, even if they recur on a frequent basis, may be of little significance.

Commission Statement at 77 (footnote omitted). The Commission Statement also requires a consideration of factors thought to facilitate collusive conduct:

> The most relevant factors appear to be: the homogenity (or fungibility) of products in the market; the number of buyers (as well as sellers); the similarity of producers' costs, the history of interfirm behavior, including any evidence of previous price fixing by the firms at issue; and the stability of market shares over time.

Id. at 80. *Accord,* G. Hay & D. Kelly, "An Empirical Survey of Price Fixing Conspiracies," 17 *J. of Law & Econ.* 13 (1974), *reprinted in* T. Calvani & J. Siegfried, *Economic Analysis and Antitrust Law* 135 (1979).

We now turn to a consideration of the effects of the acquisition on competition. Judge Barnes found that AMI's acquisition of French

Hospital produced an extremely high concentration in both the city and county hospital markets. (ID 155) As a result of the acquisition, he concluded that AMI increased its market share from 55.6% to 75.5% in the county market and from 57.8% to 87% in the city market, measured on the basis of inpatient days.[11] The Herfindahl-Hirschman Index increased from 3818 to 6025 in the county market and from 4370 to 7775 in the city market, also measured on the basis of inpatient days.[12] AMI apparently does not dispute any of these statistics on appeal.[13] Judge Barnes also examined a number of the [29] "qualitative" factors that the Commission Statement (and Justice Guidelines, as well) would require. As a result of the acquisition of French Hospital, AMI faces little or no competition in either market. AMI's only competitor in the city market is San Luis General Hospital, a smaller and older facility that lacks modern equipment and high quality nursing services. (IDF 132, 135) Within the county market, the only other competitor is Twin Cities Community Hospital, also smaller and unable to offer a full range of hospital services. AMI is the top firm in both markets; and there is a considerable size disparity between AMI and its competitors. (ID 156) There has been little volatility in the market shares of hospitals in San Luis Obispo County. (RX 5804; IDF 177) Barriers to entry, in the form of the Planning Act's certificate-of-need requirements, are very high, and in light of excess capacity in the market, new entry is extremely unlikely. (ID 156) AMI does not dispute Judge Barnes' assessment of these "qualitative" factors. Taken together, these are strong indicia of the likely anticompetitive effects of the acquisition.

AMI counters this strong evidence by arguing that the acquisition did not lessen competition or enhance AMI's market power because French and Sierra Vista hospitals did not engage in price competition. Specifically, AMI disputes Judge Barnes' findings that Sierra Vista's pricing was restrained by French prior to the acquisition and that AMI had the ability to charge noncompetitive prices after the acquisition. (RAB 43) AMI makes several separate arguments in support of this. First, AMI maintains that under the third-party payment system (which, AMI alleges, accounts for in excess of 90% of hospital payments in San Luis Obispo County) hospital bills are paid on the basis of costs (Medicare, Medicaid, and Blue Cross) or charges based on costs (private hospital insurance), which are set by statute, rule, or contract and are not affected by the existence of or pricing by competing facilities. Thus, AMI asserts that as a practical matter the acquisition could not increase AMI's ability to raise its prices. Second, AMI contends that price competition can be said to exist only if a material number of consumers would respond to a price increase by doing business elsewhere, and that Judge Barnes conceded that patients seldom chose among hospitals on the basis of price. (RAB 44) Third, AMI maintains that data depicting gross charges per adjusted hospital admission and movements in annual charge levels strongly suggest that competitive conditions are not present in these markets. (RAB 45) Fourth, AMI contends that Judge Barnes' finding that some patients are sensitive to price is contrary to record evidence. Specifically, AMI maintains that there is no evidence that Sierra Vista reduced its charges in response to patients' "concern" about prices or that reports on comparative hospital charges in [30] any way induced price competition. Although AMI concedes that officials at French and Sierra Vista were "mindful" of each others "visible" charges, AMI contends that this did not translate into price competition because there was no evidence that a material number of patients chose a hospital on the basis of these visible charges and that any reduction in these visible charges could be (and, in the case of French Hospital in 1978, were in fact) offset by increases in "invisible" charges. With regard to evidence that French waived its usual fee for the use of its emergency rooms on weekends, AMI asserts that that did not result in any additional use of French's emergency rooms and had no effect on physicians' admitting patterns. And finally, AMI attacks Judge Barnes' conclusion that, following AMI's acquisition of French, the "lack of restraint on AMI's pricing conduct" enabled it to raise charges to compensate for a low census at French, as having no basis in the record because before the acquisition neither hospital reduced prices in order to increase census and in fact both hospitals increased charges despite low patient census. (RAB 47)

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[11] Measured on the basis of gross hospital revenues, the comparable figures are 52.2% to 71.3% and 53.3% to 82.4%, respectively, for the county and city markets.

[12] Based on gross hospital revenues, the increase was from 3518 to 5507 in the county market and from 3996 to 7097 in the city market.

[13] These figures are, of course, well in excess of the threshold that applies under the Justice Guidelines where the post-merger index is in excess of the 1800 point level, and tell a revealing story of the competitive conditions within those markets.

We do not endeavor to recapitulate the basis for our conclusion that price competition exists in this market, albeit "attenuated," "reduced," or "diminished." Regrettably, a large part of AMI's argument above focuses on this precise issue, not on the more narrow issue of whether the acquisition has lessened or is likely to lessen competition in these markets. But we do find that on the basis of the evidence in the record, AMI's acquisition of French Hospital has already lessened price competition and is likely to continue to lessen price competition, to the extent that any price competition remains. Two points need to be made. First, price competition clearly existed between French and Sierra Vista with regard to "visible" items that the market could expect might affect patients in deciding (or in conferring with physicians in the decision as to) which hospital to patronize (to the extent that the patient's illness permitted such an election to be made). Price competition took place regarding room rates, operating room rates, and emergency room rates. Hospital administrators were aware of this competition and were sensitive to the need to remain competitive on these items. The record amply demonstrates that this price competition resulted in reductions for some of these charges at French. Although any reductions in these "visible" charges could conceivably be offset by increases in "invisible" charges, we cannot conclude that this competition did not have any salutary effects. For instance, in the case where French's "other charges" were increased in 1978 (so that total charges paid by a surgical patient were higher) while the operating room fee was lowered, AMI cites to no record evidence establishing a causal link between the two and ignores the fact that these reductions may have helped to limit the size of the increase in overall charges that was in fact implemented. (*see* RAB 46 n.56) Furthermore, as Complaint Counsel notes in its Answering Brief (CAB 30), hospitals are limited in their ability to increase charges for some "invisible" services to offset a **[31]** reduction in "visible" charges. Below average profits earned by AMI's Santa Cruz Hospital on both room charges and charges for ancillary services demonstrate this point. (CAB 30; *see* CX 1054N) Second, after the acquisition of French, AMI took unequivocal steps to reduce or altogether eliminate the competition that previously had existed between French and Sierra Vista. In 1980, AMI attempted to make charges uniform at all of its hospitals in the San Luis Obispo area. For instance, a memorandum to French's administrator, Mr. Bowytz, recommended that charges for certain items be changed, noting that "these price changes will establish uniformity for the San Luis Obispo area." (CX 301A; *see also* 302A) The Friesen report recommended as an "action item" to "standardize fee structure for AMI hospitals." (RX 5435Z69) Sierra Vista's competition with French ended after AMI's acquisition of French: in an interview conducted by a Friesen representative, administrator Bowytz noted that he "fe[lt] tied" and couldn't "compete along traditional lines" because the "competition is AMI." (CX 295W) The AMI Quality Assurance Report for Sierra Vista also concluded that competition would be reduced:

> For many years Mr. Carlson and his forces [at Sierra Vista] have challenged the French Hospital and won the battle, now *that* activity has to be curbed and a balance of cooperation mixed with healthy competitiveness has to be reached whilst retaining hard earned standards of care.

(CX 425F (emphasis in original)) Thus, the adverse impact of AMI's acquisition of French Hospital is readily apparent.

AMI appears to be arguing that given the very little price competition that exists in these markets, that competition does not benefit consumer welfare because of pervasive price regulation in the industry and, accordingly, the antitrust laws should be neutral because price competition does not function to augment consumer welfare. This is contrary to a number of cases that have applied the Clayton Act to acquisitions in industries with attenuated price competition. As Judge Barnes noted, the Supreme Court rejected a similar argument in *United States v. Philadelphia National Bank,* 374 U.S. 321 (1963), involving the banking industry, where governmental regulation was pervasive:

> [W]e reject the position that commercial banking, because it is subject to a high degree of governmental regulation, or because it deals in the intangibles of credit and services rather than in the manufacture or sale of tangible commodities, is somewhat immune from the anticompetitive effects of undue concentration. Competition among banks exists at every level—price, variety **[32]** of credit arrangements, convenience of location, attractiveness of physical surroundings, credit information, investment advice, service charges, personal accommodations, advertising, miscellaneous special and extra services—and it is keen; on this appellees' own witnesses were emphatic. There is no reason to think that concentration is less inimical to the free play of competition in banking than in other service industries. On the contrary, it is in all probability more inimical.

374 U.S. at 368–69 (footnote deleted).[14] And in *Stanley Works v. FTC,* 469 F.2d 498 (2d Cir. 1972), the Court of Appeals concluded that Section 7 was particularly applicable to an acquisition in the cabinet hardware industry, which was "a concentrated market manifesting limited signs of price competition," 469 F.2d at 505.[15] These cases clearly suggest that even assuming that the **[33]** limited price competition that does exist in these markets may produce only marginal benefits in terms of overall consumer welfare, the antitrust laws will

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[14] In *Philadelphia National Bank,* as in this case, there was substantial evidence that although price competition was reduced, there was considerable nonprice competition. The Court quoted with approval the following testimony from the record:

> Q. What form does the competition take? Is it competition in price?
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> A. No, I wouldn't say that it is competition as to price. After all, interest rates are regulated at the top level by the laws of the 50 states.
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> * * * * * * *
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> I do not believe that competition is really affected by the price area. I think it is affected largely by the quality and the caliber of service that banks give and whether or not they feel they are being received in the right way, whether they are welcome in the bank. Personalities enter into it very heavily, but I do not think price as such is a major factor in banking competition. It is there, it is a factor, but not major.

374 U.S. at 368 n.45.

[15] The court's condemnation of that acquisition is particularly apposite to this case:

> Finally, we note that though a market may be concentrated, forces may operate so as to maintain some level of competition and thus preserve the possibility of eventual deconcentration. That is why the continued independence of companies with relatively small market shares is so crucial to the health and vitality of a market threatening to become oligopolistic.

469 F.2d at 508 (footnote deleted).

endeavor to protect this price competition, if, for nothing else, the hope that price competition will be enhanced.

AMI also contends that nonprice competition in these markets was not lessened as a result of AMI's acquisition of French because nonprice competition did not exist to any appreciable degree. AMI disputes Judge Barnes' finding that hospitals in San Luis Obispo "competed to attract doctors to admit to their facility . . . [and] to satisfy the needs of the doctors who were already admitting there" (IDF 134), arguing that due to polarization in the physician community in San Luis Obispo, physicians there rarely used their control over admissions to force hospitals to purchase equipment or improve services. Although AMI concedes that this may happen in other communities, AMI knew of only "one ten-year old instance . . ., which uncontradicted testimony establishes was unique, ..." (RAB 48) AMI alleges that the practical impact of this polarization was that "doctors in San Luis Obispo were not at all likely to shift their admissions from French to Sierra Vista or vice versa" and, consequently, "neither hospital had a practical opportunity to induce the physicians associated with the other to switch their allegiance." (RAB 49) AMI also criticizes Judge Barnes' Initial Decision for failing to recognize that hospitals have strong incentives, other than nonprice competition, to enhance services and maintain quality. For instance, under the third-party payment system, hospitals increase revenues by providing equipment and services that are needed by their staffs, which AMI argues continues to be true even after its acquisition of French Hospital. (RAB 50) Also, hospitals are subject to strong regulatory and other nonmarket pressures to maintain a high quality standard of care, such as licensure and accreditation requirements as well as the fear of medical malpractice suits. (RAB 50 n.63) Most importantly, AMI contends that Complaint Counsel has not introduced any evidence showing that the quality of care at either French or Sierra Vista declined after the acquisition.

The record does not support AMI's position. We have already concluded that substantial nonprice competition exists in these markets,[16] and we need not repeat the basis for our conclusions here. The record is replete with instances in which hospitals in San Luis Obispo endeavored to attract physicians by upgrading **[34]** equipment or services. French attempted to attract physicians in this manner, according to the testimony of Dr. Boyd:

> The hospital, the partners, tried to improve the services to attract more physicians to admit their patients to French Hospital. I think that the most notable example would be with the ophthalmologists.

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[16] *See* pages 9–12 *supra.*

> They obtained additional equipment that the ophthalmologists wanted and, as a result, now most of the ophthalmology is being done at French Hospital as opposed to the fact that it used to be done at Sierra Vista Hospital.

(Tr. Boyd 368; *see also* Tr. Bernhardt 1250) When the new French Hospital was built in 1972, the administration "tried to furnish the necessary instruments and the equipment that would encourage physicians to use French Hospital," such as special equipment for a particular neurosurgeon in the city. (Tr. Anderson 232–33) In the early 1970's Drs. Boyd and Cletsoway began switching admissions from Sierra Vista to French after their suggestions for urology equipment for the new French Hospital were followed. This apparently led to Sierra Vista purchasing similar equipment in an effort to recapture this business, as Dr. Boyd testified:

> Sierra Vista Hospital decided to upgrade their equipment in order to move us back, and they acquired some new equipment but it wasn't as good equipment as French had.
>
> So we told them we wouldn't come back until they had as good equipment as French. I think it took about two weeks and they had the other equipment, so that they had exactly the same equipment as French had.

(Tr. Boyd 356) Apparently, San Luis Obispo General Hospital also ordered the same equipment so as to attract Dr. Boyd, although Dr. Boyd apparently did not begin using that hospital for urological surgery until San Luis Obispo General actually received that equipment approximately eighteen months later. (Tr. Boyd 356) The record contains numerous other examples. (*See, e.g.,* Tr. Harvey 1685–86, Schwam 585–86, 593) Hospitals also competed for physicians by maintaining high quality nursing staffs (Tr. Boyd 361; Bernhardt 1297–98) and qualified medical staffs (Tr. Lave 826–27, Carlson 1323). The hospitals understood the importance of satisfying physician needs to retain business, as Mr. Anderson, the former administrator at French, explained: **[35]**

> Obviously I didn't want my patients going to Sierra Vista or any other hospital for that matter. So we did try to create an environment which would encourage [physicians] to continue bringing their patients to French Hospital.

(Tr. Anderson 231) AMI recognized that this nonprice competition existed. (CX 197G) The record also demonstrates that despite AMI's argument to the contrary, physicians in San Luis Obispo would and in fact did switch admissions because of this nonprice competition. (*See, e.g.,* Tr. Boyd 368, 356, Bernhardt 1250) AMI acknowledged in internal documents that physicians were switching patronage between hospitals (CX 56F), notwithstanding the polarization in the community that AMI asserts existed. Also, a number of physicians admitted patients to both Sierra Vista and French (*see* Tr. Boyd 364–66, 409), again notwithstanding this asserted polarization, and members of the French Clinic also used hospitals other than French (Tr. Harvey 1697, Anderson 248–49). AMI expressed concern about the prospect of losing physicians as a result of one form of this nonprice competition. Mr. Carlson, administrator of AMI's Sierra Vista Hospital, noted in his May 1978 "Monthly Operations Report":

> An unknown factor in physician utilization of the hospital is the increasing number of physicians who have been invited to buy into the French Hospital. As of this date, I have not been able to obtain any useful information, except that three men have joined the hospital as owners.

(CX 317B) Mr. Carlson's "Monthly Operations Report" for November 1978 underscored this concern:

> A problem of major concern is that of competition from French Hospital. Because of doctor ownership, past increases in the number of physicians and possible future additions to the Clinic makes that hospital an increasingly formidable competitor for the limited number of patients in the area. Although the census has remained at approximately the same level, additions to the Clinic could have significant adverse effects on Sierra Vista Hospital.

(CX 318B) Thus, although this polarization might in theory have had some restraining effect on the physicians' ability to respond to this nonprice competition by shifting admissions, in practice it does not appear to have done so. The record suggests that any **[36]** polarization that may have existed did not "chill" nonprice competition (or at least the need to engage in nonprice competition that was perceived by hospital administrators) among hospitals in San Luis Obispo. Thus, AMI's focus on the theoretical barriers that physician polarization created for hospitals in San Luis Obispo to engage in nonprice competition is largely off the mark. The most important evidence, and on which we principally rely in affirming Judge Barnes' finding of liability, is the record evidence that AMI's acquisition of French Hospital virtually eliminated the nonprice competition that existed between hospitals in San Luis Obispo. An AMI internal memorandum evidences this:

> For many years Mr. Carlson and his forces have challenged the French Hospital and won the battle, now *that* activity has to be curbed and a balance of cooperation mixed with healthy competitiveness has to be reached whilst retaining hard earned standards of care . . . . The monopoly of the hospital market can only remain constructive if the above situation is achieved . . . .

(CX 425F) As noted previously, Mr. Bowytz, AMI's administrator at French after the acquisition, indicated in an interview conducted by Friesen that he could not compete with Sierra Vista along traditional lines, such as "steal[ing]" physicians away from Sierra Vista, because "competition is AMI." (CX 295W) Two hearing witnesses, Complaint Counsel economist Lester Lave and Dr. Schwam, testified that physicians in San Luis Obispo lost their "leverage" to promote improvements in hospital services or equipment by threatening to shift admissions to French Hospital:

> So [I] and other members of the medical staff felt that having French Hospital as an independent entity was valuable in keeping our hospital—I won't call it up to the state of the art, [it is] still really quite behind—but at least keeping it roughly in range. When French Hospital was acquired by AMI that leverage was lost. [37]

(Tr. Schwam 585–86)[17] AMI has not introduced any meaningful evidence to contradict the effect of this nonprice competition or any meaningful evidence to contradict the effect of the elimination of this nonprice competition in San Luis Obispo. We conclude that this nonprice competition merits protection by the antitrust laws, even the more so because of the "attenuated" nature of price competition in the health care industry. *See Northern Pacific Railway Co. v. United States,* 356 U.S. 1, 12 (1958). [38]

D. *Competitive Effects of the Acquisition: Potential Competition*

AMI disputes Judge Barnes' reliance on "the *potential* for price competition" among hospitals in San Luis Obispo in his conclusion that AMI's acquisition of French violated the antitrust laws. (ID 161 (emphasis added)) Judge Barnes concluded that potential competition exists for the business of group purchasers of hospital services, such as health maintenance organizations, self-insured businesses, and preferred provider plans, which had incentives to negotiate with hospitals for hospital care at the lowest cost and began receiving preferred rates from hospitals as early as 1978 (IDF 113–15), although apparently not in San Luis Obispo to any significant degree (IDF 116). He also found that "[i]n 1982, the California Legislature enacted three bills permitting the Medi-Cal program to contract for inpatient hospital services . . . . The objective of Medi-Cal contracting is to stimulate competition among hospitals for Medi-Cal patients, which did not exist before."[18] (IDF 117) AMI attacks Judge Barnes' reliance on these findings on two grounds. First, AMI contends that there is no evidence that competition for the business of third-party providers has ever occurred in San Luis Obispo or that development of competition of this kind was anything other than a "speculative possibilit[y] at the time of the acquisition."[19] (RAB 51) Second, AMI maintains **[39]** that Judge Barnes' reliance on these changes in state health care law as a source of potential competition contravenes "well-established antitrust standards" because this legislation "was completely unrelated to the acquisition and was enacted long after that transaction had closed." (RAB 51) AMI contends that in relying on the Medi-Cal legislation to find a lessening of the potential for competition Judge Barnes "was forced to extend the time-of-suit rule in an unprecedented and fundamentally unfair manner." (RAB 51) AMI argues that the Supreme Court has never invalidated a merger or acquisition on the basis of post-acquisition developments that were unrelated to the defendant's conduct (RAB 54) and that no case holds that a merger may be retroactively challenged on the basis of post-acquisition developments that are not an outgrowth of the transaction itself (RAB 55).

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[17] Dr. Lester Lave explained more fully the effect of the acquisition in terms of physician leverage:

> Up until the acquisition, French offered [a] major point of threat, a major one that physicians practicing outside of French, at Arroyo Grande or Sierra Vista, or [San Luis Obispo] General could use on their hospital administrator in order to induce some kind of change, some improvement in behavior. Those effects are very important effects in terms of nonprice competition and they were terribly important in disciplining hospital administrators in other hospitals. And when French was acquired a lot of that went away.

(Tr. Lave 899–900)

A review of the relevant case authorities suggests that Judge Barnes correctly invoked the time-of-suit rule in this case by taking cognizance of the passage of the Medi-Cal legislation. The seminal case examining the time-of-suit rule is *United States v. E. I. du Pont de Nemours & Co.*, 353 U.S. 586 (1957), in which the Supreme Court held unlawful du Pont's acquisition of shares of General Motors stock, notwithstanding the fact that the suit was commenced some thirty years after the time of acquisition. The post-acquisition evidence focused on du Pont's dominant position as General Motors' principal supplier of automotive finishes and fabrics that it achieved as a result of its acquisition of General Motors stock. The Court concluded:

> Section 7 is designed to arrest in its incipiency not only the substantial lessening of competition from the acquisition by one corporation of the whole or any part of the stock of a competing corporation, but also to arrest in their incipiency restraints or monopolies in a relevant market which, as a reasonable probability, appear at the *time of suit* likely to result from the acquisition by one corporation of all or any part of the stock of any other corporation.

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[18] The legislation also permits Blue Cross and other commercial health insurance companies to contract with selected hospitals for services for their subscribers, which will have the effect of increasing price competition between hospitals for this business. (IDF 123)

[19] AMI makes specific reference to three findings in the Initial Decision in support of its argument that the Initial Decision is based only on "possibilities":

> (1) that the effects of the acquisition on the new Medi-Cal program are "illustrative of the injury possible to group purchasers of hospital services," IDF 184; (2) that "it is possible" an HMO might be formed in San Luis Obispo in the future, IDF 183; and (3) that self-insured employers in San Luis Obispo "might well" seek to negotiate discounts with local hospitals. IDF 158.

(RAB 51)

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> "Incipiency" in this context denotes not the time the stock was acquired, but any time when the acquisition threatens to ripen into a prohibited effect. *See* **[40]** *Transamerica Corp. v. Board of Governors,* 206 F.2d 163, 166.
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> We repeat, that the test of a violation of § 7 is whether, at the *time of suit,* there is a reasonable probability that the acquisition is likely to result in the condemned restraints. The conclusion upon this record is inescapable that such likelihood was proved as to this acquisition. The fire that was kindled in 1917 continues to smolder. It burned briskly to forge the ties that bind the General Motors market to du Pont, and if it has quieted down, it remains hot, and, from past performance, is likely at any time to blaze and make the fusion complete.

353 U.S. at 589, 597, 607, (footnote deleted; emphasis added). *See also United States v. Penn-Olin Chemical Co.,* 378 U.S. 158, 168 ("In any event, Penn-Olin was engaged in commerce at the time of suit and the economic effects of an acquisition are to be measured at that point rather than at the time of acquisition.") But in *United States v. Continental Can Co.,* 378 U.S. 441 (1964), in which defendants at trial introduced post-acquisition evidence of the absence of anticompetitive effects of the challenged acquisition, the Supreme Court held that the trial court "erred in placing heavy reliance" on this evidence in dismissing the action since the evidence principally related to defendants' post-acquisition conduct and "[defendant] Continental was under some pressure because of the pending government antitrust suit." 378 U.S. at 463. In *FTC v. Consolidated Foods Corp.,* 380 U.S. 592 (1965), the Supreme Court deemphasized what could be regarded as exculpatory "objective" post-acquisition evidence of the competitive effects—changes in industry market shares and unsuccessful attempts to engage in reciprocal buying—of Consolidated Foods' acquisition of one of its spice suppliers:

> The Court of Appeals, on the other hand, gave post-acquisition evidence almost conclusive weight. It pointed out that, while Gentry's share of the dehydrated onion market increased by some 7%, its share of the dehydrated garlic market decreased 12%. 329 F.2d, p. 626. It also relied on apparently unsuccessful attempts at reciprocal buying. *Ibid.* the Court of Appeals concluded that "Probability can best be gauged by what the past has taught." *Id.*, p. 627. [41]
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> The Court of Appeals was *not in error in considering the post-acquisition evidence* in this case. *See United States v. du Pont & Co.*, 353 U.S. 586, 597 *et seq.*, 602 *et seq.* But we think it gave *too much weight* to it. *Cf. United States v. Continental Can Co.*, 378 U.S. 441, 463. No group acquiring a company with reciprocal buying opportunities is entitled to a "free trial" period. To give it such would be to distort the scheme of § 7. The "mere *possibility*" of the prohibited restraint is not enough. (*United States v. du Pont & Co., supra,* p. 598.) Probability of the proscribed evil is required, as we have noted. If the post-acquisition evidence were given conclusive weight or allowed to override all probabilities, then acquisitions would go forward willy-nilly, the parties biding their time until reciprocity was allowed fully to bloom. It is, of course, true that

> post-acquisition conduct may amount to a violation of § 7 even though there is no evidence to establish probability *in limine. See United States v. du Pont & Co., supra,* pp. 597–598. But the force of § 7 is still in probabilities, not in what later transpired. **[42]**

380 U.S. at 598 (emphasis added). *Accord, FTC v. Procter & Gamble Co.,* 386 U.S. 568, 576 (1967).[20] And the Court in *United States v. General Dynamics Corp.,* 415 U.S. 486 (1974), found that evidence of post-acquisition changes in the patterns and structure of an industry —there, the coal industry—might be considered in assessing the probable future anticompetitive effect of an acquisition. The government, in its reliance on market statistics based on past production, did not consider coal reserves needed for negotiating future long-term supply contracts. The future competitive impact of the merger was more accurately gauged by measuring access to such reserves, because long-term contracts constituted the competitive reality in the industry. The Court emphasized that "the essential question remains whether the probability of such *future* impact exists at the time of trial." 415 U.S. at 505. In this regard, the Court clarified the limited role of post-acquisition evidence in that case by distinguishing genuine changes in industry and market **[43]** conditions and trends from specific post-acquisition competitive conduct under control of the merger parties:

> In *FTC v. Consolidated Foods Corp.,* 380 U.S. 592, 598, this Court stated that post-acquisition evidence tending to diminish the probability or impact of anticompetitive effects might be considered in a § 7 case. *See also United States v. E. I. du Pont de Nemours & Co.,* 353 U.S. 586, 597 *et seq.,* 602 *et seq.* But in *Consolidated Foods, supra* and in *United States v. Continental Can Co.,* 378 U.S. at 463, the probative value of such evidence was found to be extremely limited, and judgments against the Government were in each instance reversed in part because "too much weight" had been given to post-acquisition events. The need for such a limitation is obvious. If a demonstration that no anticompetitive effects had occurred at the time of trial or of judgment constituted a permissible defense to a § 7 divestiture suit, violators could stave off such

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[20] But the Commission opinion in that case expressed a reluctance to accept post-aquisition evidence:

> Specifically, we think that the admission of post-acquisition data is proper only in the unusual case in which the structure of the market has changed radically since the merger—for example, where the market share of the merged firm has dwindled to insignificance—or in the perhaps still more unusual case in which the adverse effects of the merger on competition have already become manifest in the behavior of the firms in the market.

In re Procter & Gamble Co., 63 F.T.C. 1465, 1559 (1963). However, it is clear that the Commission in that case was concerned with exculpatory "subjective" post-acquisition evidence, *i.e.,* evidence of events or conduct that were within the defendants' exclusive control. *See id.* (["A] respondent, so long as the merger is the subject of an investigation or proceeding, may deliberately refrain from anti-competitive conduct—may sheathe, as it were, the market power conferred by the merger—and build, instead, a record of good behavior to be used in rebuttal in the proceeding.") *See also United States v. Continental Can Co.,* 378 U.S. 441, 463 (1964); *Lektro-Vend Corp. v. Vendo Co.,* 660 F.2d 255, 276 (7th Cir. 1981), *cert. denied,* 455 U.S. 921 (1982). This, of course, is not the case in the matter at bar since passage of the Medi-Cal legislation and its impact on price competition between hospitals is entirely beyond the control of AMI. *Accord, United States v. General Dynamics Corp.,* 415 U.S. 486, 504 (1974).

> actions merely by refraining from aggressive or anticompetitive behavior when such a suit was threatened or pending.
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> In this case, the District Court relied on evidence relating to changes in the patterns and structure of the coal industry and in United Electric's coal reserve situation after the time of acquisition in 1959. Such evidence could not reflect a positive decision on the part of the merged companies to deliberatively but temporarily refrain from anticompetitive actions, nor could it reasonably be thought to reflect less active competition than that which might have occurred had there not been an acquisition in 1959 . . . . Such evidence went directly to the question of whether future lessening of competition was probable, and the District Court was fully justified in using it.

415 U.S. at 504–06 (footnote deleted). *See also Lektro-Vend Corp. v. Vendo Co.*, 660 F.2d 255, 276–77 (7th Cir. 1981), *cert. denied,* 455 U.S. 921 (1982); *United States v. International Harvester Co.*, 564 F.2d 769, 777–80 (7th Cir. 1977); *Varney v.* [44] *Coleman Co.*, 385 F.Supp. 1337, 1345–46 (D.N.H. 1974); *United States v. Falstaff Brewing Corp.*, 383 F.Supp. 1020, 1027 (D.R.I. 1974), *on remand from* 410 U.S. 526 (1973). Here, in the case at bar, it is clear that changes in the competitive structure of the market resulting from adoption of Medi-Cal legislation are relevant to the effects of the acquisition on that market. It is equally clear that any changes that may result from operation of the Medi-Cal scheme would largely be beyond the control of AMI. Thus, consideration of post-acquisition evidence of the adoption and effects of the Medi-Cal legislation is appropriate here.

The probative value that should be ascribed to this evidence is another issue, however. In each of the decisions discussed above, the post-acquisition evidence was of known events that could be corroborated. In the *du Pont* case, du Pont's dominance as General Motors' principal supplier of automotive fabrics and finishes was demonstrable. In *General Dynamics,* the Court was able to point to the changes in the structure of the coal industry with some degree of certainty. We can say with certainty that the California Legislature has adopted the Medi-Cal legislation which, as the Judge Barnes found, is intended to stimulate competition among hospitals for Medi-Cal patients. (IDF 117) We can also say with some degree of certainty that the success of Medi-Cal contracting in achieving costs savings depends in large measure on competition among hospitals for Medi-Cal contracts. But we cannot say with any degree of certainty what the effects of the Medi-Cal legislation would have been in San Luis Obispo, but for AMI's acquisition of French, because we do not know what the demonstrable impact of the Medi-Cal legislation has been anywhere else, and Complaint Counsel has not introduced any evidence establishing that. Complaint Counsel asks us to blindly accept the argument that the objectives of the Medi-Cal legislation—cost savings generated from increased price competition between hospitals—will be realized, and realized in the way that the Medi-Cal legislation intended. Had Complaint Counsel established this—for instance, through evidence of actual price competition and cost savings generated in other communities through "Medi-Cal type" negotiating—the deleterious impact of AMI's acquisition on price competition in San Luis Obispo would be more easily ascertainable. But here, there is no evidence that Medi-Cal works. To assume that it will is mere speculation. We find that evidence of the effects of the Medi-Cal legislation, if it can be described as evidence at all, is entitled to very little probative weight. Thus, we cannot conclude on the basis of the record before us that AMI's acquisition of French Hospital eliminated "the potential for price competition," and we rule that Judge Barnes erred in so holding.

E. *Efficiencies Resulting From the Acquisition*

AMI contends that appreciable cost savings are likely to be achieved as a result of its acquisition of French and the consolidation of French and Sierra Vista hospitals. AMI **[45]** estimates these savings at $1.2 million in annual operating expense savings and one-time capital expense savings of $12.2 million. (*See* RX–5614) AMI's estimate of operating expense savings assumes that all medical services (except laboratory facilities) currently being provided by French and Sierra Vista will be consolidated and that the hospital at which a particular medical service is consolidated will provide the service at the lower unit cost presently being achieved by French or Sierra Vista. AMI's estimate of the $12.2 projected capital expense savings reflects the difference between the $8.7 million figure that AMI estimates it would incur in implementing the consolidation plan and the $20.9 million that would be required to maintain Sierra Vista as a "first-rate hospital" in the event that there was no consolidation and AMI were forced to divest French. AMI's estimates of these savings were referenced in the Friesen consolidation study (*see* RX–5435Z61; RX–5436Z66; Tr. Mittelstaedt 1041–42) and subsequently quantified by Robert Mittelstaedt (*see* RX–5614), who supervised the Friesen study. (*See also* Tr. Schramm 2402)

Judge Barnes rejected AMI's efficiencies "defense" because of the difficulties inherent in accurately gauging the alleged efficiencies and in balancing these cost savings against the anticipated increase in market power. (ID 176) He made a number of findings in support of this conclusion. First, he found that it was not clear that consolidation of French and Sierra Vista would occur because consolidation would require the preparation of detailed implementation plans and the approval of AMI's Executive Committee and the Board of Directors of each of the hospitals. (ID 167–68) He also found that a number of practical barriers could prevent implementation of the consolidation: no consolidation on this scale had ever been accomplished before; physicians who currently practice at one hospital might resist relocation of their specialties to the other hospital; and AMI would need approval from the local HSA and the State of California to make most of the capital expenditures required to consolidate French and Sierra Vista. (ID 168) Second, Judge Barnes concluded that it was questionable whether economies of scale, such as the $1.2 million of operating expense savings alleged by AMI, actually could be gained through consolidation. He noted that AMI's own economic expert, Dr. Schramm, concluded that there was inconsistent evidence as to the existence of scale economies for hospitals. (ID 168–69) Third, Judge Barnes found that AMI had not taken any significant steps towards consolidation of French and Sierra Vista during the seventeen month period between the acquisition of French and the time that AMI learned of the Commission's investigation of the acquisition. He noted that AMI internal documents concluded that the proposed consolidation would only produce "somewhat, not **[46]** enormously, potential lower costs."[21] (RX 5435C; *see* ID 169) Fourth, Judge Barnes concluded that the estimate of operating cost savings contained in the Mittelstaedt study made a number of questionable assumptions and omissions that had the effect of overstating the amount of savings that would result from consolidation of French and Sierra Vista hospitals.[22] (ID 170–72) Fifth, Judge Barnes concluded that, assuming that the consolidation was not implemented, it was not certain that AMI [47] would be willing to spend the $21 million that it contended was necessary to maintain Sierra Vista as a "first-rate hospital." He attributed this to several things. AMI presented no proof that such expenditures would be necessary. Even assuming that the improvements in Sierra Vista are needed, he concluded that AMI may not be willing to spend $21 million in a market area that, according to AMI internal documents, "does not present an ideal situation in terms of market growth and development" and where "[g]rowth in the community is not expected to be high enough to justify major capital expenditures across the board of AMI hospitals."[23] (RX 5435Z66) AMI would also need certificate-of-need authorization to make the changes envisioned by the Mittelstaedt study, and Judge Barnes concluded that California's health planning authorities will closely scrutinize these expenditures to determine whether the improvements were necessary and whether more modest improvements would suffice.[24] And finally, Judge Barnes found there to be inconsistencies between AMI's $20.9 million estimate and other record evidence, which he attributed to the fact that "[i]t is in AMI's interest to make these capital costs appear as high as possible to accentuate the supposed savings to be realized from consolidating with French." (ID 174)

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[21] The administrator of Sierra Vista, in a 1981 memorandum, apparently concurred with this assessment:

> It was my hope that our long range plans would permit consolidation of some services with the eventual objective of at least a slight decrease in the rate at which expenses are increasing. *Even though such cooperative efforts would not necessarily be of major dollar savings*, they would have been at least symbolic of our united efforts to hold down costs.

(CX 1063A (emphasis added))

[22] Judge Barnes criticized the Mittelstaedt study, as follows. The study assumes that a consolidated service could be provided at one location for both hospitals at the lower unit cost of the two hospitals, although in some instances the service would be provided by the higher cost hospital. Attribution of a portion of these savings to more effective purchasing arrangements is incorrect, because joint purchasing involving separate-owned hospitals is fairly common in California and, consequently, consolidation is not necessary to achieve these savings. The study ignores the cost of capital for the $8.7 million expenditure required to consolidate French and Sierra Vista. The study also ignores the cost of depreciation on facilities and renovations that are built in the course of this consolidation. The study fails to include salary increases that would be required because of additional responsibilities that would have to be taken on by existing personnel after the consolidation. The projected operating cost savings for laboratory tests ignores the need to maintain two laboratories after the consolidation. The study assumes, without explanation, certain savings in consolidation of laundry and food services. The study fails to include the administrative expenses associated with implementation of the consolidation by AMI personnel. The study also fails to take into account the cost of physically transporting personnel, goods, and specimens between French and Sierra Vista after the consolidation, since the hospitals are two miles apart. (ID 170–72)

On first impression, it appears that the case law has adopted a slight bias against accepting efficiency justifications in merger cases. However, a correct reading of Supreme Court precedent in this area demonstrates that lower courts' reliance on statements contained in these Supreme Court opinions for rejection of an efficiencies defense is misplaced. A careful examination of these statements reveals that they are dicta only. In *Brown Shoe Co. v. United States,* 370 U.S. 294 (1962), the Justice Department challenged the merger of G. R. Kinney Company and the Brown Shoe Company, both of which manufactured and retailed shoes. In finding the merger to be illegal, the district court accepted the Justice Department's argument that the merger was anticompetitive because, *inter alia,* it lowered **[48]** prices to the extent that independent retailers could no longer compete in the low and medium-priced shoe markets. *See United States v. Brown Shoe Co.,* 179 F.Supp. 721, 738 (E.D. Mo. 1959). On appeal to the Supreme Court, Brown Shoe argued that the vertical integration that resulted from the merger did not produce any economic efficiencies; the Justice Department contended that the merger caused lower costs, lower prices, and better quality. In its opinion, the Court set forth what has been generally regarded to be a condemnation of the efficiency defense:

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[23] Judge Barnes concluded that AMI could actually build a new hospital for considerably less than the $20.9 million that it estimated would be needed to renovate Sierra Hospital. Using AMI's own estimates, which indicate that AMI can build hospitals at a cost averaging $50,000 to $60,000 per bed, AMI could build a new fully equipped hospital, with the 50 bed addition contemplated by the Mittelstaedt study, for approximately $13 million, some $7 million less than AMI's estimated cost of renovating Sierra Vista.

[24] Specifically, Judge Barnes found that more than $3.1 million of the proposed capital expenditures, for the addition of 50 beds in the late 1980's, may not be approved because San Luis Obispo County currently has excess capacity, a situation which is likely to continue into the future. (ID 173–74)

> A third significant aspect of this merger is that it creates a large national chain which is integrated with a manufacturing operation. The retail outlets of integrated companies, by eliminating wholesalers and by increasing the volume of purchases from the manufacturing division of the enterprise, can market their own brands at prices below those of competing independent retailers. Of course, some of the results of large integrated or chain operations are beneficial to consumers. Their expansion is not rendered unlawful by the mere fact that small independent stores may be adversely affected. It is competition, not competitors, which the Act protects. But we cannot fail to recognize Congress' desire to promote competition through the protection of viable, small, locally owned businesses. Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization. We must give effect to that decision.

370 U.S. at 344 (footnote deleted). However, it is obvious that since Brown Shoe did not argue efficiency as a defense (but the *absence* of efficiency as a defense), the Court was not presented with, and did not address, the issue of efficiency as a justification. *See* Muris, "The Efficiency Defense Under Section 7 of the Clayton Act," 30 *Case W. Res. L. Rev.* 381 (1980). In *United States v. Philadelphia National Bank,* 374 U.S. 321 (1963), it appeared that the Supreme Court was rejecting Philadelphia National Bank's efficiency justification for the acquisition when the Court stated:

> This brings us to appellees' final contention, that Philadelphia needs a bank larger than it now has in order to bring business to the area and stimulate its [49] economic development . . . . We are clear, however, that a merger the effect of which "may be substantially to lessen competition" *is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial.* A value choice of such magnitude is beyond the ordinary limits of judicial competence, and in any event has been made for us already, by Congress when it enacted the amended § 7. Congress determined to preserve our traditionally competitive economy. It therefore proscribed anticompetitive mergers, the benign and the malignant alike, fully aware, we must assume, that some price might have to be paid.

374 U.S. at 371 (emphasis added). Philadelphia National Bank was clearly *not* arguing an efficiencies defense, but only that the local community would benefit from a larger bank, a "socio-political" justification. The Court explicitly recognized that it was *not* entertaining (and, presumably, not condemning) an efficiencies defense:

> There was evidence that Philadelphia, although it ranks fourth or fifth among the Nation's urban areas in terms of general commercial activity, ranks only ninth in terms of the size of its largest bank, and that some large business firms which have their

> head offices in Philadelphia must seek elsewhere to satisfy their banking needs because of the inadequate lending limits of Philadelphia's banks; . . . .
>
> Appellees offered testimony that the merger would enable certain *economies of scale*, specifically, that it would enable the formation of a more elaborate foreign department than either bank is presently able to maintain. *But this attempted justification, which was not mentioned by the District Court in its opinion and has not been developed with any fullness before this Court, we consider abandoned.*

374 U.S. at 334 n.10 (emphasis added). *See also United States v. Phillipsburg National Bank,* 399 U.S. 350 (1970) (alleging pro-competitive effects, that "by enhancing their competitive position, it would stimulate other small banks in the area to become more aggressive in meeting the needs of the area," not benefiting consumers by reducing operating costs) And in *FTC v.* **[50]** *Procter & Gamble Co.,* 386 U.S. 568 (1967), it again appeared that the Supreme Court was intending to condemn the efficiencies defense when it said:

> Possible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition. *See Brown Shoe Co. v. United States, supra,* at 344.

386 U.S. at 580. However, as in *Brown Shoe,* it does not appear that an economies defense was ever asserted by Procter & Gamble. The Court did refer to the cost savings for advertising and sales promotion that would be available because of Procter & Gamble's large volume purchasing in these areas. But Procter & Gamble did not develop the anticipated savings in sales, distribution, and manufacturing that would result from the acquisition as a factor offsetting any anticompetitive effects. In fact, as in *Brown Shoe,* the Court actually viewed the economies in advertising and sales promotion as an anticompetitive effect of the acquisition since the volume discounts that were made available to Clorox by virtue of the acquisition would have the effect of discouraging new entry into the bleach market. *See* 386 U.S. at 579. Thus, on the basis of *Brown Shoe, Philadelphia National Bank, Phillipsburg National Bank,* and *Procter & Gamble,* it appears that the Supreme Court has stated, in dicta only, a bias against assertion of the efficiencies justification in Section 7 cases,[25] and those statements do not appear in the context of an efficiencies defense.

There is language appearing in several cases that suggests that efficiencies should be considered in antitrust analysis, in general, and under Section 7, in particular. The Supreme Court's opinion in *North-*

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[25] The Supreme Court's decision in *Ford Motor Co. v. United States,* 405 U.S. 562 (1972), on which Judge Barnes relied in his Initial Decision (ID 175), makes no reference to pro-competitive effects of the acquisition in the form of scale economies.

ern Pacific Railway v. United States, 356 U.S. 1 (1958), identifies economic efficiency as one of the principal goals of antitrust:

> The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will **[51]** yield *the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress,* while at the same time providing an environment conducive to the preservation of our democratic political and social institutions.

356 U.S. at 4 (emphasis added). In *United States v. United States Gypsum Co.,* 438 U.S. 421, 442 n.16 (1978), the Supreme Court characterized economic efficiency as procompetitive ("The exchange of price data and other information among competitors does not invariably have anticompetitive effects; indeed such practices can in certain circumstances increase economic efficiency and render markets more, rather than less, competitive.") The Court relied heavily on economic analysis of competitive effects in *Continental T.V. v. GTE Sylvania, Inc.,* 433 U.S. 36 (1977), stating that the rule of reason analysis requires the fact-finder to "weigh[ ] *all of the circumstances* of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition," 433 U.S. at 49 (emphasis added; footnote deleted). The Court has also indicated a desire to consider economic evidence in assessing the legality of mergers under Section 7, as demonstrated in *United States v. General Dynamics Corp.,* 415 U.S. 486 (1974) and *United States v. Marine Bancorporation, Inc.,* 418 U.S. 602 (1974). The emphasis on economic analysis displayed by the Court in recent decisions has led several circuit courts of appeal to consider scale economies in assessing mergers under Section 7. For instance, in *Fruehauf Corp. v. FTC,* 603 F.2d 345 (2d Cir. 1979), the Second Circuit Court of Appeals explicitly found scale economies in the manufacture of heavy duty truck wheels to be a procompetitive factor in favor of the acquisition. And in *Marathon Oil Co. v. Mobil Corp.,* 669 F.2d 378 (6th Cir. 1981), *cert. denied,* 455 U.S. 982 (1982), the Sixth Circuit Court of Appeals recognized operating and scale efficiencies that could arise as a result of the merger as one factor to consider in analyzing the competitive impact of the merger. *See* 669 F.2d at 380, 382. These cases have required that such efficiencies be established by substantial evidence.[26] **[52]** *See*

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[26] A number of legal scholars have written in support of the efficiency defense in Section 7 cases. Professor Sullivan writes in his treatise:

> [W]here cost saving efficiencies are clear, and arise in a context where market forces will oblige the seller to pass them on to consumers, and where competitive harm is only speculative (as for example where the basis for the challenge to the merger is an increased concentration in some setting near the *prima facie* threshold), the wise course is to risk the possible social harm for the certain benefit. Even if the court is not ready to weigh the social benefit of efficiencies against the social harm of competitive injury when both seem similarly likely or certain to eventuate, it might nevertheless value a significant and likely social benefit higher than a much more doubtful harm.

(footnote cont'd)

Fruehauf Corp. v. FTC, 603 F.2d 345, 358 (2d Cir. 1979). *Accord, Marathon Oil Co. v. Mobil Corp.*, 669 F.2d 378 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982) ("convincing evidence"). This is especially so because of the inherent difficulty in identifying and quantifying the efficiencies bearing on Section 7 liability.

In this case, we find that AMI did not establish, with any certainty, that substantial efficiencies exist. Giving AMI *all* the benefits of the many doubts that exist with regard to the Mittelstaedt study, AMI estimates that the consolidation will produce only a 5.6% reduction in operating costs. (RX 5614 B, K) Assuming that these cost savings can be realized, AMI does not establish that they will necessarily inure to the benefit of consumers; in fact, AMI's own economic expert, has suggested the contrary.[27] Certainly if we were to accept AMI's assertion that **[53]** "reimbursement [under Medicare, Medicaid, and Blue Cross] is limited by customary and reasonable charges determined on a regional or nationwide basis" (RAB 43–44), realization of the cost savings may not directly impact the prices charged at French and Sierra Vista and paid by third-party payers. However, AMI's assertion of the efficiencies defense does not satisfy any of the criteria set forth by any of the authorities. Without going into the item-by-item and line-by-line assertions and counter-assertions by AMI and Complaint Counsel, we agree with Judge Barnes that AMI has failed to establish with substantial evidence the existence of the cost savings from the acquisition. (*See* ID 166–74) AMI has not demonstrated to any degree that these efficiencies are already enjoyed by one or more firms in the industry. AMI has not demonstrated to any degree that these efficiencies could not be achieved within a comparable period of time through a merger that threatened less competitive harm, such as a combination of San Luis Obispo General Hospital and either French or Sierra Vista.[28] *See generally* Justice Guidelines at p. 63–64. AMI does not show that these efficiencies "clearly outweigh any in-

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Sullivan, *Antitrust* 631 (1977). *See also* Areeda & Turner, Antitrust Law ¶939–62 (1980); Bork, *The Antitrust Paradox* (1978); Muris, "The Efficiency Defense Under Section 7 of the Clayton Act," 30 *Case W. Res. L. Rev.* 699 (1977); Leibeler, "Market Power and Competitive Superiority in Concentrated Industries," 25 *U.C.L.A. L. Rev.* 1221 (1978).

[27] Dr. Schramm has written:

> [T]he merger movement [in the hospital industry] must be seen in the light of consumer satisfaction. Clearly, absolute consumer choices suffer as consolidations advance. This is traditionally rationalized by citing reductions in unit prices that follow consolidation. Interestingly, however, prices do not always reflect the savings of consolidation and artificial price settings must be controlled through regulation. The apparent risk in consolidation from the consumer perspective is that prices may not reflect true savings.

(CX 1048T) Dr. Schramm has also concluded that "[e]mpirical research . . . leads one to the uneasy conclusion that economies of scale may or may not exist for hospitals" (CX 1048P (footnote deleted)) and that "[c]urrent research has not demonstrated conclusively that hospital consolidation automatically leads to increased efficiency and reduced levels of real spending per capita for hospital care" (CX 1048T).

[28] Contrary to AMI's assertions in its Reply Brief, it is clear that a merger between San Luis Obispo General Hospital and either French or Sierra Vista would have less anticompetitive impact, at least in terms of diminution of nonprice competition, than the merger under consideration, given that French served as Sierra Vista's primary competition in terms of quality of service.

crease in market power" that we have concluded results from AMI's acquisition of French, an increase in market power that we find is "both severe and clearly evident." *See* Muris, "The Efficiency Defense Under Section 7 of the Clayton Act," 30 *Case W. Res. L. Rev.* 381, 426 (1980); RRB 18 n.27. And, given AMI's complete dominance of the general acute care health services market in these two geographic markets, as a result of the acquisition, it is unlikely that AMI can show that "market forces will oblige [AMI] to pass [cost saving efficiencies] on to consumers." *See* Sullivan, *Antitrust* 631 (1977). Accordingly, we find that AMI has not made a sufficient showing that such efficiencies exist to warrant their consideration as a procompetitive effect and to be balanced against the anticompetitive impact of this acquisition. **[54]**

F. *Conclusion*

We conclude on the basis of the foregoing that AMI's acquisition of French Hospital has and will substantially lessen competition or tend to create a monopoly of general acute care health services in the San Luis Obispo County and the City of San Luis Obispo in violation of Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act.

V. ATTEMPT TO MONOPOLIZE

Judge Barnes held that AMI attempted to monopolize the relevant product and geographic markets, which constitutes an unfair method of competition in or affecting commerce in violation of Section 5 of the Federal Trade Commission Act. AMI appeals this holding, contending that Judge Barnes' ruling ignores AMI documents contemporaneous to the acquisition that establish that AMI's intent in acquiring French "was to make a profitable investment that would promote health planning goals." AMI also maintains that the ruling ignores case law precedent holding that an acquisition, standing alone, does not satisfy the "specific intent" or "unlawful conduct" elements of the attempted monopolization course of action. (RAB 59)

Judge Barnes concluded in his Initial Decision that each of the three elements of the attempted monopolization offense was satisfied in this case. *See Swift & Co. v. United States,* 196 U.S. 375, 396 (1905). Specifically, he concluded that AMI's acquisition of French constituted anticompetitive conduct designed to further its attempt to monopolize, and that because the acquisition had the effect of eliminating AMI's principal competitor and produced a large increase in market share, the acquisition itself provided a sufficient basis for a finding of attempted monopolization. (ID 162–63) Judge Barnes found that, as evidenced by contemporaneous documents authored by AMI Vice

Presidents Loftin and Danko (CX 38B; CX 41C–D), AMI officials involved in the decision to acquire French clearly anticipated the exclusionary effect of the acquisition, demonstrating AMI's specific intent to monopolize. (ID 163–64) Judge Barnes also concluded that there was a dangerous probability that AMI would be successful in its attempt to monopolize the hospital services markets in the City of San Luis Obispo and San Luis Obispo County, and that success was actually achieved, given that AMI controlled over 80% of the city market and over 70% of the county market. (ID 165; *see* CX 425F)

Although AMI's appeal of Judge Barnes' finding of liability for attempted monopolization presents several novel issues that could be examined by this Commission, we decline to do so here. We have already found that AMI's acquisition of French violated Section 7 of the Clayton Act and, with it, Section 5 of the Federal Trade Commission Act. We have ordered an appropriate remedy to correct this violation. We do not believe that it is necessary to consider whether AMI engaged in attempted **[55]** monopolization in further violation of Section 5 for purposes of the remedy ordered here. Accordingly, we will not do so.

VI. REMEDY

Having decided that AMI's acquisition of French Hospital violates Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act, we now turn to a consideration of the appropriate remedy to be ordered in this case. Judge Barnes ordered that AMI divest all assets, rights, and privileges that it obtained in conjunction with the French acquisition, and prohibited AMI for a period of ten years from acquiring, without the prior approval of the Commission, any hospital located within a thirteen state area.[29] (*See* ID 192–94 (¶¶II & III)) **[56]**

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[29] More specifically, the Order proscribes acquisitions of any hospital located in Oregon, California, Texas, Oklahoma, Missouri, Arkansas, Louisiana, Mississippi, Alabama, Georgia, Florida, South Carolina, or North Carolina, if:

> A. The hospital to be acquired is within a Standard Metropolitan Statistical Area ("SMSA") in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a twenty (20) percent or more share of the licensed general acute care hospital beds within that SMSA; or
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> B. The hospital to be acquired is not within an SMSA but is within a county in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a twenty (20) percent or more share of the licensed hospital beds within that county; or
>
> C. The hospital to be acquired is (1) not within an SMSA or a county in which AMI already operates a hospital, but is within thirty (30) miles of a hospital which AMI already operates in another SMSA or county, and (2) the hospital to be acquired and any hospital(s) that AMI operates combined have a twenty (20) percent or more share of the licensed hospital beds in the area within thirty (30) miles of the midpoint between the hospital to be acquired and any hospital operated by AMI.
>
> *Provided, however,* That no acquisition shall be subject to this Section III if the consideration to be paid for the hospital, including assumption by AMI of liabilities of its present owners, does not exceed one million dollars ($1,000,000).

(ID 193–94)

AMI appeals Judge Barnes' prior approval order on two principal grounds.[30] First, AMI argues that the prior approval requirement is not reasonably related to AMI's conduct in this case because the order extends beyond the relevant geographic markets involved here. (RAB 66) AMI contends that a broad order that is to apply beyond the relevant geographic markets can be justified under the case law only when a "knowing and deliberate violation" or a "likelihood of repeated unlawful conduct" has been shown, which Complaint Counsel has failed to do. AMI criticizes Judge Barnes' reliance on *Ekco Products Co.*, 65 F.T.C. 1163 (1964), *Beatrice Foods Co.*, 68 F.T.C. 1003 (1965), and *Liggett & Myers, Inc.*, 87 F.T.C. 1074 (1976), all of which did not involve fencing-in provisions applicable outside the relevant markets, but instead focused on the appropriateness of such provisions in cases involving a nationwide market found to be highly concentrated, which AMI argues is not the case here. Second, AMI argues that the prior approval requirement would be contrary to public interest because it would reduce existing competition for the purchase of hospitals that are put up for sale. (RAB 69–70) AMI contends that because of delays and uncertainty attendant to Commission review of proposed acquisitions, the prior approval requirement "would foreclose AMI from effective participation in the typical bidding contest held by hospitals looking for a buyer" and would "disable AMI since neither it nor a prospective seller could confidently predict the outcome." (RAB 73)

Judge Barnes concluded that the prior approval requirement was warranted because of the merger trend in the hospital industry and AMI's history of growth through acquisition. He noted that the Commission has consistently utilized prior approval as a tool in merger law enforcement: since January 1983 all nine consents that have either been ordered or provisionally accepted contained prior approval requirements, and three of the four that involved local or regional geographic markets required prior approval for all acquisitions anywhere in the country. He also rejected AMI's contention that the prior approval requirement will handicap it in bidding for hospitals, concluding **[57]** that because of possible certificate-of-need and Hart-Scott-Rodino requirements, time is not as significant in the acquisition process as AMI posits.

We begin by noting that "[t]he Commission has wide discretion in its choice of a remedy deemed adequate to cope with . . . unlawful practices" and "the courts will not interfere except where the remedy selected has no reasonable relation to the unlawful practices found to exist." *Jacob Siegel Co. v. FTC,* 327 U.S. 608, 611, 613 (1946). *See also FTC v. Ruberoid Co.,* 343 U.S. 470, 473 (1952). Although it is well-settled that once a violation of law is established by the Government "all doubts as to the remedy are to be resolved in its favor," the courts, in civil proceedings, "are not authorized . . . to punish antitrust violators, and relief must not be punitive." *United States v. E. I. du Pont de Nemours & Co.,* 366 U.S. 316, 326, 334 (1961). Although divestiture is the usual remedy in the case of Section 7 violations, *see, e.g., United States v. E. I. du Pont de Nemours & Co.,* 366 U.S. 316, 328–31 (1961), the Commission "acts within the limits of its authority when it bars repetitions of similar conduct with other parties," *FTC v. Ruberoid Co.,* 343 U.S. 470, 473 (1952), and the Commission has the authority to impose prior approval requirements, *see, e.g., Abex Corp. v. FTC,* 420 F.2d 928 (6th Cir.), *cert. denied,* 400 U.S. 865 (1970).

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[30] AMI relegates its appeal of the divestiture order to a footnote. (*See* RAB 66 n.84) Divestiture would clearly work to restore both price and nonprice competition that we have found existed between French and Sierra Vista prior to the acquisition, and consequently we categorically reject AMI's assertion that divestiture would be punitive in this instance.

The Commission and the courts have employed numerous standards in determining whether a broad remedial order, such as a prior approval requirement, is appropriate. In *United States v. W. T. Grant Co.,* 345 U.S. 629 (1953), in which the United States sought to enjoin defendants from violating Section 8 of the Clayton Act, the Supreme Court identified the appropriate standard to be whether "there exists some *cognizable danger of recurrent violation,* something more than the mere possibility which serves to keep the case alive." 345 U.S. at 633 (emphasis added). In *Litton Industries, Inc. v. FTC,* 676 F.2d 364 (9th Cir. 1982), the Ninth Circuit Court of Appeals considered "whether the respondents acted in blatant disregard and utter disregard of the law, and whether they had a history of engaging in unfair trade practices" in determining whether a nationwide multi-products advertising ban bore a reasonable relation to deceptive advertising of a single product. 676 F.2d at 371. In *Sears, Roebuck & Co. v. FTC,* 676 F.2d 385 (9th Cir. 1982), also involving a nationwide multi-products advertising ban, the Ninth Circuit characterized this test to be whether the "advertiser's conduct shows a ready willingness to flout the law . . . ." 676 F.2d at 392. However, as is readily apparent, none of these cases involves the standards to be employed in a Section 7 case, and because the policy considerations at play in these cases may be different from those in a Section 7 case, we will not apply these to the case at bar.

Instead, we will look for guidance to Section 7 cases in which the Commission has adopted a prior approval requirement. In *Jim Walter Corp.,* 90 F.T.C. 671, 764 (1977), the Commission cited [58] respondent's history of growth in the roofing products industry, a series of more than twenty acquisitions during the ten-year period preceding issuance of the complaint, as the principal justification for ordering a ten-year prior approval requirement. In *Marquette Cement Manu-*

facturing Co., 75 F.T.C. 32, 104 (1969), the Commission found that respondent's acquisition of a ready-mixed concrete company contributed to the anticompetitive trend towards vertical integration in the cement industry, and imposed a ten-year prior approval requirement on future acquisitions by respondents. The Commission justified imposing a ten-year approval requirement in *Liggett & Myers, Inc.,* 87 F.T.C. 1074, 1140 (1976), on the basis of the oligopolistic conditions that the Commission found to exist in the dog food industry, and that it would "prevent[ ] [respondent] from eliminating through acquisition any of the few remaining independent companies which represent significant competition." In *Beatrice Foods Co.,* 68 F.T.C. 1003, 1006 (1956), the Commission stated that "[p]rophylactic relief, not merely the after-the-fact remedy of divestiture, is essential if the Congressional policy expressed in Section 7 of the Clayton Act is to be effectively carried out . . . ." The Commission held that a ten-year prior approval requirement was necessary because

> respondent and several other large national dairy companies have embarked on extensive and far-reaching programs of acquisitions whose effect has been the substantial increase of concentration in the industry, and the elimination of a middle tier of local or regional companies capable of furnishing effective competition. The mergers also eliminated respondent and other leading dairy firms as sources of potential competition in these concentrated local markets. If competition in this industry is to be restored and maintained, it is essential that this continuing elimination of viable local or regional competitors through acquisition be halted now and that respondent be restored as a potential competitor by precluding it from entering local markets by acquisition.

68 F.T.C. at 1005–06. As further justification, the Commission cited imposition of similar prohibitions on respondent's leading competitors. And in *Ekco Products Co.,* 65 F.T.C. 1163, 1222 (1964), although the Commission expressed concern about respondent's repeated efforts to restrict competition by acquiring new entrants to the commercial meat-handling equipment market, the Commission's principal rationale for the prior approval requirement was that these acquisitions permitted respondent to retain its monopoly position against new competition. Thus, from these cases we conclude that it is industry market structure and market conditions, not whether a "knowing and deliberate violation" or a "likelihood of repeated **[59]** unlawful conduct" has been shown, as AMI asserts, that determines the appropriateness of imposing a prior approval requirement in a particular case. Consequently, we must look at the record evidence of market conditions present in the general acute health care services industry to determine whether the ten year prior approval remedy ordered by Judge Barnes is appropriate here.

Complaint Counsel argues that market conditions necessitate imposition of a prior approval requirement. The record shows that in 1972, 6.5% of the beds in community hospitals were controlled by for-profit entities; by 1980, that had grown to 8.8%. (RX 5719; ID 185) In the years 1975–1981, the five largest proprietary hospital chains have acquired a total of 192 general acute care hospitals, (CX 608; Tr. Silvia 794–95; ID 186), three of which were acquired in 1975 and 80 of which were acquired in 1981. (ID 186) AMI has acquired nineteen general acute care hospitals since 1980, and intends to acquire hospitals in the future at a rate of between four and six hospitals a year. (CX 430A, C, L, W; ID 186) AMI currently owns, operates, or has under construction 75 hospitals in the United States, nearly all of which were apparently obtained through acquisition. (ID 186) In addition to this, AMI argues that more than a dozen other hospital chains are also actively engaged in acquiring hospitals and that some large hospitals are acquiring other hospitals in their local areas; most of the acquisitions have been made in the "Sunbelt" because of that region's rapid population growth and relatively unrestrictive regulation of hospitals; with this emphasis on acquisitions in the "Sunbelt," there is a greater chance that AMI will acquire hospitals near those it already owns and that concentration in local markets where AMI acquires hospitals will be higher because of acquisitions by other firms; and that AMI's efforts, at least in the case of its acquisition of French, have focused on elimination of its most significant competitor in the local market. (CAB 66–67)

We cannot agree with Complaint Counsel. Although the record evidence clearly indicates that the hospital industry is undergoing a move towards increased consolidation, on the basis of this evidence we are unable to assess the effects of those changes on competitive conditions within the multitude of local and regional geographic markets that may exist for hospital services. Our reading of the record does not indicate any basis for defining the parameters of these markets, determining concentration levels or changes in concentration levels in these markets as a result of the acquisitions that are taking place in this industry, or assessing whether the acquisitions have had either the effect of entrenching monopolists or increasing competition between market participants. Complaint Counsel asks us in essence to assume that acquisitions in this industry, *per se*, are anticompetitive. Although we have concluded that this acquisition is violative of Section 7, we cannot assume on the basis of this record that market conditions and market structure **[60]** in this industry are such that all such acquisitions, even under the conditions adopted by the prior approval remedy, are necessarily anticompetitive.

In reaching this conclusion, we find that AMI's presence in the hospital market as a potential purchaser of local hospitals that are put up for sale has a substantial potential procompetitive impact, and that the proposed prior approval requirement will uniquely debilitate or perhaps entirely eliminate AMI as a competitor in this market. Notwithstanding Complaint Counsel's arguments and Judge Barnes' findings to the contrary, we believe that time is of the essence in negotiations for the purchase of local hospitals, and that the ability to make a purchase commitment with some degree of certainty of obtaining the necessary regulatory approvals is an important element in this negotiating process. The prior approval requirement would uniquely disable AMI in these negotiations. On at least one earlier occasion, in its decision in *Beatrice Foods Co.,* 68 F.T.C. 1003, 1006 (1965), the Commission justified the prior approval remedy on the ground that it would put respondent on an equal footing with its leading competitors. Here, such a requirement would clearly put AMI on an unequal footing with its principal competitors. And there is no evidence in the record that indicates that AMI retains monopoly or dominant status in other local markets, as was the case in *Ekco Products Co.,* 65 F.T.C. 1163, 1223 (1964), so as to encourage the erosion of that monopoly position by hampering AMI's acquisition efforts.

Instead of requiring AMI to obtain prior approval from the Commission for acquiring other hospitals under the conditions set forth by Judge Barnes, we believe that many of Complaint Counsel's more legitimate objections to such acquisitions can be satisfied by requiring AMI simply to notify the Commission of its intention to make an acquisition of the variety contemplated by Judge Barnes' order. This would enable the Commission to investigate an acquisition that appears to involve significant antitrust problems, and take enforcement action against the acquisition before the acquisition has progressed beyond the "point of no return," while at the same time preserve the procompetitive benefits attributable to AMI's presence in the acquisition market. This is not intended to replace Hart-Scott-Rodino filing requirements that may apply to any of AMI's future acquisitions, but is to apply to AMI's hospital acquisitions which, for one reason or another, may be exempt from those filing requirements. We contemplate that notification by AMI of such acquisitions is to be provided when AMI's Board of Directors or Executive Committee authorizes issuance of a letter of intent or enters into a purchase agreement to make such an acquisition, whichever is earlier. **[61]**

An appropriate order[31] requiring the divestiture by AMI of French

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[31] Complaint Counsel requests that several technical modifications be made to Judge Barnes' Order, relating to the description of the geographic markets, stock divestiture, and limitations on the applicability of the Order. (CAB 73-74) AMI does not appear to object to these modifications, and they will be ordered to the extent that they are not inconsistent with our modifications to the remedy ordered by Judge Barnes.

Hospital and prior notification of acquisitions by AMI of the variety contemplated by Judge Barnes' Order is appended.

OPINION OF COMMISSIONER PERTSCHUK CONCURRING IN PART AND DISSENTING IN PART

I concur in the majority's decision to require AMI to divest the acquired assets that are the subject of this case. However, I dissent from the majority's unwillingness to require AMI, for a period of ten years, to obtain Commission approval prior to making further acquisitions under the limited circumstances ordered by the ALJ. Instead of the customary prior approval order the majority simply requires AMI to notify the FTC before it makes certain future acquisitions.

The FTC has consistently ordered a ten year prior approval requirement as a standard remedy in cases under Section 7 of the Clayton Act.[1] As a "fencing in" provision, a prior approval order is prophylactic in nature and may be ordered to "simply [2] insure that any future market acquisition is not anticompetitive. This supervisory provision puts a tolerable burden on [a company's] future conduct and is clearly within bounds of reasonableness."[2] In *Beatrice Foods Co.,* 68 F.T.C. 1003, 1006 (1956), the Commission found a violation of Section 7, ordered divestiture and included a prior approval clause in the order:

> If competition in this industry is to be restored and maintained, it is essential that this continuing elimination of viable local or regional competitors through acquisition be halted now and that respondent be restored as a potential competitor by precluding it from entering local markets by acquisition [without the Commission's approval]. . . . Prophylactic relief, not merely the after-the-fact remedy of divestiture, is essential if the congressional policy expressed in Section 7 of the Clayton Act is to be effectively carried out.

A prior approval provision also serves to deter other firms from violating the Clayton Act as well as to prevent the firm under order from repeatedly violating the law in the future.[3]

The majority articulates no reason for departing from the usual rule in this case. Instead, the majority states that "we cannot assume on the basis of this record that market conditions and market structure in this industry are such that all such acquisitions, even under the conditions adopted by the prior [3] approval remedy, are necessarily anticompetitive." (Maj. Op. at 60)

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[1] As a matter of course the Commission has required a prior approval clause in recent Section 7 consent orders. *Great Lakes Chemical Corp.,* D. 9155 (May 23, 1984) [103 F.T.C. 467]; *Flowers Industries, Inc.,* D. 9148 (Nov. 3, 1983) [102 F.T.C. 1700]; *Dairymen Inc.,* D. 9143 (Sept. 20, 1983) [102 F.T.C. 1151]; *Coca-Cola Co.,* C–3113 (Aug. 3, 1983) [102 F.T.C. 1102]; *Grand Union Co.,* D. 1921 (July 18, 1983) [102 F.T.C. 812]; *Xidex Corp.,* D. 9146 (May 1, 1983) [102 F.T.C. 1]; *Allied Foods Co.,* 101 F.T.C. 721 (1983); *Gulf & Western Industries, Inc.,* 101 F.T.C. 707 (1983); *Con Agra Inc.,* 101 F.T.C. 50 (1983); *Canada Cement Lafarge Ltd.,* 100 F.T.C. 563 (1982); *Batus Inc.,* 100 F.T.C. 553 (1982); *General Electric Co.,* 99 F.T.C. 422 (1982); *Gifford-Hill-American Inc.,* 99 F.T.C. 372 (1982); *Leigh Portland Cement Co.,* 98 F.T.C. 856 (1981); *Godfrey Co.,* 97 F.T.C. 456 (1981); *National Tea Co.,* 96 F.T.C. 42 (1980). *See also Ekco Products Co.,* 65 F.T.C. 1163 (1969); *Jim Walter Corp.,* 90 F.T.C. 671 (1977); *Marquette Cement Manufacturing Co.,* 75 F.T.C. 32 (1969); *Beatrice Foods,* 68 F.T.C. 1003 (1956); *Warner Communications, Inc.,* D. 9174 (March 19, 1984) (complaint).

[2] *Yamaha Motor Co. v. FTC,* 657 F.2d 971 (8th Cir. 1981), *cert. denied,* 456 U.S. 915 (1982).

[3] *See* my dissenting statement in *Damon Corp.,* 101 F.T.C. 689, 693 (1983).

This statement misconstrues the purpose of a prior approval order. A prior approval remedy does not operate as a ban on future acquisitions. If the Commission could now determine that subsequent acquisitions would be anticompetitive, it could presumably ban those acquisitions now. By contrast, a prior approval order merely requires a company that has been found to violate the law to seek Commission permission before making certain future acquisitions.

The majority also argues that a prior approval remedy will "uniquely disable" AMI, in that "time is of the essence" in negotiations for hospital acquisitions, and that prior approval is time consuming and would cause significant delays preventing AMI from effectively participating in this negotiation process. (Maj. Op. at 60) The majority's argument, which was rejected by the ALJ, (Maj. Op. at 57) is unsupported by any record evidence, and the opinion cites none. There is no explanation of how a prior approval requirement would adversely affect AMI's lawful, subsequent hospital acquisition activity. Contrary to AMI's assertions that bidding and negotiations for hospitals proceed at a rapid pace, Judge Barnes found that hospital negotiations are typically "lengthy", and concluded "that because of possible certificate-of-need and Hart-Scott-Rodino requirements, time is not as significant in the acquisition process as AMI posits." (ID 188–89) The majority simply disagrees with this conclusion without citation, presumably basing its decision on its own [4] unspecified general expertise. Even though an order for prior approval may involve time delays, there is no reason why the FTC could not in a proper case expedite AMI's request for approval.

Finally, the Commission majority states that in order to determine if a ten year prior approval remedy is appropriate "we must look at the record evidence of market conditions present in the general acute health care services industry." (Maj. Op. at 59) An examination of that record reveals that AMI has acquired 19 general acute care hospitals since 1980 and in the future intends to acquire 4 - 6 hospitals per year. (*Id.*) AMI also currently owns, operates or has under construction 75 hospitals in the U.S., nearly all of which were obtained through acquisition. (*Id.*) Judge Barnes concluded from this evidence that the "prior approval requirement was warranted because of the merger trend in the hospital industry and AMI's history of growth through acquisition." (Maj. Op. at 57) Specifically with respect to the latter reason, Judge Barnes found that "because of health planning laws which limit opportunities for the development of new hospitals, AMI will continue to seek to grow through acquisitions in the future. Thus, a prior approval clause is a necessary remedial provision." (ID 187)

The ten year prior approval remedy ordered by Judge Barnes is limited in scope to 13 states where AMI currently owns hospitals and applies only if AMI would have at least a twenty percent share of the market after the acquisition. Furthermore, AMI will not be subject to the order unless an acquisition by AMI [**5**] exceeds $1,000,000. Judge Barnes' ten year prior approval order is, in his own words, more narrow than "past Commission precedent" (ID 189).

A prior notification requirement is an inadequate substitute for a prior approval clause. After a law violation has been found by the Commission it is perfectly appropriate, for a limited period, to shift the presumption of legality of respondent's future acquisitions from the Commission to the respondent.

It is not clear what kind of evidence the majority would require in future cases before it ordered the kind of carefully limited prior approval requirement that Judge Barnes ordered in this case or that the Commission ordered regularly in past cases and consents. Respondents will doubtless resist prior approval clauses, both in litigated orders and consents, on the ground that some as yet unspecified standard was not met. While I concede there might be some exceptional case when a prior approval requirement is unwarranted, this is not such a case. Only by ignoring the record and the ALJ's findings and conclusions in this case can the majority reach a different result.

STATEMENT OF COMMISSIONER BAILEY CONCURRING IN PART AND DISSENTING IN PART

I agree completely with the opinion of the Commission that American Medical International's (AMI) acquisition of French Hospital in San Luis Obispo, California, violated Section 7 of the Clayton Act, and that the hospital should be ordered divested. I dissent only because the Commission has declined to require respondent to obtain FTC approval for a limited class of future acquisitions of acute care hospitals likely to raise antitrust concerns. Prior approval relief was a primary purpose of this litigation; failure to order such relief here means the Commission has won a lawsuit but lost a cause.[1]

My dissent on the prior approval issue is grounded on three points. First, this case originated out of concern with respondent AMI's rapid growth by repeated horizontal acquisitions of hospital facilities, part of a merger trend among proprietary hospital chains. The French

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[1] *U.S. v. E.I. du Pont de Nemours & Co.*, 366 U.S. 316, 323, 324 (1961) (quoting *International Salt Co., v. United States* 332 U.S. 392, 401 (1947)).

Hospital acquisition is merely illustrative of the larger antitrust concern. Second, contrary to the implication of the Commission that prior approval clauses should be imposed only upon completion of some form of detailed market-by-market analysis, use of such fencing-in clauses has been virtually universal in FTC Section 7 cases over at least the past twenty years. Third, there are substantial practical and [2] policy reasons supporting such relief, which serves as a prophylactic guarantee against future anticompetitive acquisitions by respondent AMI. Such prospective acquisitions will now have to be dealt with by costly and time consuming case-by-case litigation.

I.

The evidence in this record shows that the nation's five largest proprietary hospital chains, including Respondent, have acquired 192 hospitals in the period 1975–1981. In 1981 alone, these firms acquired 80 hospitals. CX 608 The Commission observes in its opinion that in 1972, the five largest proprietary hospital chains had 6.5% of community hospital beds, and that this market share had risen to 8.8% by 1980. A recent study of the Federation of American Hospitals, shows that in 1982, about 10% of U.S. acute care hospital facilities were owned by for-profit chains[2], and that the number of such hospitals had doubled between 1976 and 1982. Other analysts have predicted that for-profit chains will have up to 20% of the market by 1990.[3] [3]

AMI's President has predicted that in the next five years, acquisitions by the five largest companies will range between a combined total of 50 and 100 hospitals a year.[4] Another observer, testifying in this proceeding, said: "Within the next ten years, hospitals will be merging all over the place. It will be like a waterfall." CX 1048C, W; Schramm, 2365–66. This rapidly increasing pace of hospital acquisitions is of special significance in the "Sunbelt," the region of the U.S. where the large proprietary hospital chains have made most of their acquisitions because of that region's rapid population growth and relatively unrestrictive regulation of hospitals. Derzon, 2184–86; CX 430J–K; CX 613A–D.

AMI's holdings are concentrated in the Sunbelt states, and AMI tends to acquire hospitals near those it already owns. CX 613A–B. Almost all of AMI's hospitals have been obtained through acquisition, nineteen of them since 1980. IDF 236. By the end of 1983, AMI had grown to 77 owned or leased acute care hospitals, up from 70 in 1982. AMI plans to acquire four to six hospitals per year, and has estimated conservatively that 1000 hospitals meet its acquisition criteria. CX 430L–W. AMI's Executive Vice-President has stated:

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[2] Gray, ed., *The New Health Care for Profit: Doctors and Hospitals in a Competitive Environment*, 2, 15 (1983).

[3] Perspectives: *McGraw-Hill Washington Report on Medicine and Health*, June 6, 1983, 2.

[4] "Multi-Units Are Ready to Boost their Market Share," *Modern Healthcare*, May, 1983, 89.

> We emphatically reject the contention that the acquisition market is nearing saturation or that prices have reached levels where there is a substantial degree of risk in most situations. In our view, there are more than enough properties available at attractive prices to keep the whole industry gainfully employed for years to come. CX 4300 [4]

By the end of the decade of the 1980s, AMI estimates that the investor owned sector of this industry has the potential to double its share of the community hospital market. CX 430L. AMI's President declared in 1981:

> I can assure you that the opportunities (for acquisitions) are plentiful and that they range over the entire spectrum of acute care hospitals regardless of size or pattern of ownership. There is no doubt that AMI will continue to experience significant growth in the external area for some time to come. CX 430X.

On October 23, 1983, for example, AMI announced the acquisition of Lifemark Corporation for approximately one billion dollars.[5] Lifemark is a 25-hospital, 4629 bed chain, itself the sixth largest proprietary hospital chain in the United States. It is obvious, and the record of this proceeding clearly shows, that the Commission correctly observed that "the hospital industry is undergoing a move towards increased consolidation. . . ." (Slip Op. at 60).

I disagree with the Commission's interpretation of the evidence, because I do not believe that complaint counsel must prove the existence of actual additional antitrust violations (beyond those being litigated) in order to obtain ancillary prior approval relief. I agree with Justice Brennan when he wrote "the amended §7 was intended to arrest anticompetitive tendencies in their 'incipiency'." *United States* v. *Philadelphia National* [5] *Bank,* 374 U.S. 321, 362 (1963). I believe that such a reading of the statute is consistent with its legislative history. The Senate Report on the 1950 amendments to the Clayton Act stated, "The intent here . . . is to cope with monopolistic tendencies in their incipiency and well before they have attained such effects as would justify a Sherman Act proceeding . . . ."[6] The conclusion of the Commission, however, is that neither AMI's policy of expansion by acquisitions, nor the levels and rates of rising national hospital concentration, justify the imposition of the narrowly focused prior approval relief proposed by the ALJ and supported by complaint counsel.

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[5] "AMI, Lifemark Agree to Merge," *Hospitals,* November 16, 1983, 17. I have no knowledge or opinion as to whether any AMI acquisitions, present or future, raise antitrust concerns on their specific merits, beyond the acquisition litigated in this case. I am referencing the Lifemark acquisition only to illustrate that AMI is continuing to fulfill its announced policy of expansion through acquisition.

[6] S. Rep. No. 1775, 81st Cong., 2d Sess., 4–5 (1950).

II.

The whole context of the opinion's discussion of the standards applicable to prior approval relief implies that complaint counsel bears a considerable burden establishing the need for such an order provision.

Yet the simple fact is that 143 of the 157 litigated or settled Section 7 orders issued by the Commission in the past 20 years contain prior approval relief.[7] The almost routine entry **[6]** of this relief (91% of the orders entered, 1964–84) has occurred because an antitrust case both aims to restore competition where it already has been lost *and* seeks to insure against its loss through similar means in the future. Such ancillary "fencing-in" relief, prospective in nature, is typically broader in coverage than the specific violation and relief involved in a particular case. Further, "it is well settled that once the Government has successfully borne the considerable burden of establishing a violation of law, all doubts as to the remedy are to be resolved in its favor." *United States v. E.I. du Pont de Nemours & Co., supra,* at 334.

I have pointed out already that prior approval relief was a primary rather than a secondary focus of relief in this case—even respondent limits its appeal of the divestiture portion of this order to a single footnote in one of its briefs; its arguments against prior approval relief go on for eight pages. Both parties' unusual emphasis on a routine issue may have prompted the Commission to place an extra burden on complaint counsel—but that burden cannot be justified, either by precedent or the situation before us.

The majority concedes the Commission's power to order prior approval relief in appropriate cases. The Commission also acknowledges both that a trend is occurring towards consolidation of hospitals through merger, and that respondent AMI has participated actively in this merger wave and intends to continue to do so. Nevertheless, the Commission rejects prior approval relief here. First, it distinguishes a line of cases where the **[7]** main impetus to prospective relief was evidence of respondents' repeated willfull or knowing violation of the law, or a history of past conduct that created a "cognizable danger of recurrence" of illegal activity.[8] The Commission foreswears this line of cases, because, it claims, they do not grow out of Section 7 caselaw, and therefore are not directly applicable. The result, of course, is to trivialize strong record evidence of respondent's past and intended future course of acquisitions. On the contrary, there is Section 7 authority acknowledging "respondent's demonstrated proclivity to expansion through acquisition" as an important consideration in formulating prior approval relief. *Beatrice Foods Co.,* 68 F.T.C. 1003, 1006 (1965); *Marquette Cement Manufacturing Co.,* 76 F.T.C. 361, 371 (1969).

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[7] These numbers actually *understate* the degree to which prior approval relief is routine in Section 7 cases. Six of the 14 orders without such relief were vertical acquisitions in the cement industry. Because acquisitions in this industry were subject to a special FTC premerger reporting program from 1967 on, there was no necessity to order prior approval relief in specific cases.

[8] *United States v. W.T. Grant Co.*, 345 U.S. 629 (1953); *Litton Industries, Inc. v. FTC*, 676 F.2d 364 (9th Cir. 1982); and *Sears Roebuck & Co. v. FTC*, 676 F.2d 385 (9th Cir. 1982).

The second line of authority relied on by the Commission is a series of Section 7 proceedings where prior approval relief was asserted to have been warranted on the basis of the competitive threat to specific antitrust markets by respondent's past or likely future merger conduct.[9] According to the Commission's reading of these few cases, prior approval relief must only be ordered when complaint counsel can prove such vulnerable "industry market structure and market conditions" in specific **[8]** "local and regional geographic markets." (Slip Op. at 60) Of particular concern here, for instance, would be markets where AMI or its competitors are likely to become entrenched as monopolists, or where effects on competition can be actually assessed. Unfortunately, all the Commission has in the record before it in regard to markets other than San Luis Obispo, California, is the fact that the *national* percentage of hospital beds controlled by proprietary hospitals rose from 6.5% in 1972 to 8.8% in 1980. Such national concentration data is not numerically impressive, and is even perhaps irrelevant in an industry characterized by local and or regional markets, such as this one.[10] I do not envy the role of government staff in future cases who must heed the Commission's analysis in this regard. The Commission provides no guidance on what kind and how much evidence is necessary to obtain prior approval relief.[11] As a **[9]** generic matter, the prior approval provision personifies the prophylactic character of Section 7 of the Clayton Act[12] in curbing potentially anticompetitive increases in concentration in their incipiency. The implication of the Commission's analysis is that staff should identify markets where already there are dangerous problems of monopoly power.[13] Complaint counsel has no crystal ball, however, to aid them in predicting with any certainty the specific markets where, over the next ten years, competitive concerns *might* arise on account of possible future acquisitions by AMI.

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[9] *Jim Walter Corp.,* 90 F.T.C. 671, 764 (1977); *Marquette Cement Manufacturing Co.,* 75 F.T.C. 32, 104 (1969); *Liggett & Myers, Inc.,* 87 F.T.C. 1074, 1140 (176); *Beatrice Foods Co.,* 68 F.T.C. 1003, 1006 (1956); and *Ekco Products Co.,* 65 F.T.C. 1163, 1223 (1964).

[10] Oddly, the Commission does not cite to the strongest case for its own proposition, *ITT Continental Banking Company,* 84 F.T.C. 1349 (1974). There, complaint counsel failed to achieve a five year extension of a prior approval clause because its evidence of increasing industry wide concentration through acquisitions in the bread industry was found irrelevant to the question of whether concentration was threatening in appropriate and relevant local markets. And, in his dissent in *National Tea Co.,* 69 F.T.C. 226, 278 (1966), Commission Elman leveled criticism at a prior approval order, specifically because it was based on national concentration statistics for food retailing, rather than on an assessment of local market conditions.

[11] In *ITT, supra,* however, there is a suggestion of how to proceed: "[W]hile we agree that it can be difficult to establish the facts as to what has been happening in even a sample of three or four relevant local bread markets, we know of no principle of law that permits difficulties of proof to justify the inferring of a fact to be proved from another fact that has no *necessary* causal relation to it. Economic facts do not have to be proven with engineering precision." 84 F.T.C. at 1399.

[12] *Beatrice Foods Co.,* 68 F.T.C. 1003, 1006 (1965); *The Seeburg Corp.,* 75 F.T.C. 661, 675 (1969).

I do not read the Commission majority as stating that prior approval relief is necessarily limited to the markets pled and proved in a specific Section 7 case—in this case, one county in one state. If this were what the Commission were saying, it would go against scores of cases where prior relief provisions sweep geographically broader than those markets where divestiture relief was proved to be justified.[14] [10]

The Commission *seems* to be saying that there must be some reasonable relationship between the competitive concerns identified in a specific case, and the ancillary relief ordered in that case. Such an interpretation would be consistent with the view taken both in cases and in the legal literature.[15] The Commission and I, perhaps, then disagree only on whether complaint counsel's proof and the ALJ's order together meet a standard of reasonableness.

The prior approval relief proposed by the ALJ and rejected by the Commission majority was expressly tailored to AMI's all-to-obvious acquisition strategy. It imposed the prior approval relief only with regard to the 13 states where AMI is now present in force, based on the record evidence that AMI generally acquires hospitals near those it already owns. The prior approval relief only applied to hospital acquisitions in local geographic areas, near where AMI already owned a facility, *and* where any proposed acquisition would result in an AMI market share of 20% or more of the market, *and* the acquisition proposed exceeded one million dollars. To my mind, this is reasonably specific and narrow relief. [11]

If complaint counsel had put into the record of this proceeding figures on ownership and concentration of hospital beds for a selection of major cities and regions throughout the Sunbelt, would it had won from this Commission the prior approval relief that it sought?[16] The Commission gives no answer to this question, and the arguments that it embraces later about how respondent's unfettered role as a prospective hospital purchaser "has a substantial potential procompetitive impact," leave me somewhat puzzled about the true motives of the Commission in declining to order modest prophylactic relief.

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[13] In her concurring statement in *National Tea, supra,* at 299, 309, Commissioner Jones observed the legal futility in permitting the continuation of a series of unsupervised acquisitions in "localized markets totalling hundreds of thousands" to the point where local "direct evidence of anticompetitive impact" can be measured.

[14] It is clear that prior approval merger relief may extend to conduct beyond the scope of a complaint and record confined to specific allegedly illegal acquisitions. *Marquette Cement Manufacturing Co.,* 76 F.T.C. 361, 370, 371 (1969). The Commission has often entered relief in merger cases, extending beyond the geographic parameters of a specific complaint. ID at 188, CAB at 69, 71, 72.

[15] "Future relief (beyond divestiture), however, must be molded in light of the particular facts; the criteria of 'necessary and appropriate' and 'reasonably related' to the Section 7 offense may well be the most precise guidelines feasible in the circumstances." Duke, Scope of Relief Under Section 7 of the Clayton Act, 63 Colum. L. Rev., 1192, 1208 (1963). (citations to decision on remand in *U.S. v. E.I. du Pont de Nemours,* 1962 Trade Cas. (CCH) ¶70,245 at 75, 942).

III.

The practical and policy reasons for prior approval relief are simple. As a practical matter, once the Commission has gone through the prolonged and costly process of proving an antitrust violation, it should exercise, as it usually has in the past, some prospective authority over respondent's related conduct for a period of time to prevent likely or possible recurrences. As a **[12]** policy matter, preventing violations of the antitrust laws is preferable to unraveling them after the fact. It avoids the cost and expenses of litigation, and, in the broader sense, upholds the Clayton Act's policy of preventing, in their incipiency, the anticompetitive effects that might flow from certain acquisitions. The best example of this concern is the Hart-Scott-Rodino premerger notification process, which requires advance reporting of all corporate mergers above a certain dollar size, with waiting periods to allow antitrust analysis of such reports, and thus possible injunctive action against suspect mergers prior to consummation. Although some of the future AMI acquisitions of hospitals may be subject to Hart-Scott-Rodino reporting, many would fall below the dollar reporting levels set in that program. CX 1034; RX 5825 at 7, 27; RX 5850. Moreover, prior approval relief flowing specifically from a litigated case record such as here, amounts to a veto leverage potential which is more efficient than the injunctive litigation route associated with premerger notification.

The Commission takes the view that the prior approval provision urged by complaint counsel and recommended by the ALJ "asks us in essence to assume that acquisitions in this industry, *per se* are anticompetitive."[17] The majority misperceives the issue. The relief in question is not a ban on all future **[13]** acquisitions of acute care hospitals. On the contrary, the remedy in question simply requires respondent to petition for approval of an acquisition that qualifies for reporting under the narrow order entered by the ALJ. Past experience has simply been that most such petitions have been granted. Such petitions for acquisitions have been judged by the competitive standards applicable to any merger situation. The Commission is not free to deny prior approval where it has no reason to believe that the acquisition in question would be illegal. *Beatrice Foods Co.,* 67 F.T.C. 473, 731 n. 48 (1965). "Since these orders do not contain outright bans on future acquisitions, the approval requirement must of necessity contemplate some circumstances under which some . . . acquisitions would be approved by the Commission." *Broadway-Hale Stores Inc.,* 75 F.T.C. 374, 377 (1969) (Statement of the Commission approving acquisition subject to prior approval).

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[16] Presumably if complaint counsel had presented some facts as to the present competitive picture in various areas in the Sunbelt, the Commission could not have so likely dismissed their request for relief on the grounds that specific market facts implying antitrust concerns had not been shown. It is always possible, however, that had staff proved the conditions existing in a dozen markets, the Commission would have limited prior approval relief to those areas. However, one commentator has observed of the cases on this point that, "Future merger bans are usually limited to the particular industry involved, but only in exceptional circumstances are they limited to specified geographical areas." Rockefeller, "What Remedies are available to restore competition if a merger is declared unlawful?", *Antitrust Questions and Answers*, 248, 249 (1974).

[17] ". . . [W]e cannot assume on the basis of this record that market conditions and market structure are such that all such acquisitions, even under the conditions adopted by the prior approval remedy, are necessarily anticompetitive." (Slip Op. at 60)

Respondent's practical arguments against our imposition of this relief are that hospital merger negotiations are alleged to occur within tight time frames, and delays and uncertainty occasioned by FTC approval review procedures might unfairly hamper AMI in the "competition" to "beat" hospital chains not under FTC order in the ongoing game of making hospital acquisitions. The Commission explicitly embraces these arguments in concluding that AMI's presence in the market as a potential purchaser of local hospitals has a substantial potential procompetitive impact. This is a conclusion for which the Commission offers no record evidence. I might be more sympathetic with those arguments, but for our principle decision [14] today that AMI violated the law by one of its typical acquisitions, and our various findings regarding AMI's pattern of acquisitions and intentions for the future. The Commission, however, gives weight to the concern over impairment of AMI's private interests in making hospital acquisitions, stating that "The prior approval requirement would uniquely disable AMI in these negotiations." (Slip Op. at 60).[18] The practical validity of this statement turns, it seems to me, on the assumption that the Commission is unable to conduct its review of prior approval requests expeditiously. However, actual experience again shows that when expedited treatment is requested in petitions for prior approval, the staff and the Commission usually accommodate such requests. *See, e.g., Foremost Dairies, Inc.,* Docket No. C–1161 (approval granted one day after close of public comment period) [104 F.T.C. 548 (1984)]. The only inevitable delay in regard to such petitions is the requisite 30 day public comment period set out in the Commission's rules. Given regulatory considerations possibly requiring the issuance of Certificates of Need in regard to hospital acquisitions, the "competitive" need for FTC action prior to 30 days or so is not at all clear. Moreover, the limited notice relief ordered here by the Commission in lieu of prior approval does not give AMI absolute confidence that its **[15]** negotiations can proceed apace, uninterrupted. The limited notice filing also has some potential to leave AMI uncertain about the FTC's intentions, particularly if such notices are withheld from the public record, and therefore are beyond respondent's ability to monitor the staff's handling of any anti-approval arguments filed by various public and private parties troubled by AMI's acquisition appetite.

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[18] It is an old and familiar refrain in antitrust cases that an order against just one firm in an industry hampers its competitive struggle against other firms in the same industry that are not under order. This argument has been rejected both as a defense to wrongdoing, and to the entry of specific relief. *FTC v. Universal Rundle Corp.,* 387 U.S. 244 (1967) (citing *Moog Industries, Inc. v. FTC,* 388 U.S. 411 (1958)). *See also Ger-Ro-Mar v. FTC,* 518 F.2d 33 (1975).

Moreover, a certain amount of delay is always necessary in effective premerger notification. The great majority of reported mergers prove to be of no concern to the antitrust laws, yet firms must report nonetheless, and at some cost in time and money. Particularly burdened are those firms that fall subject to premerger "second requests", where additional cost, delay and uncertainty are injected into a reported transaction, even though in most such cases no enforcement action results. Still, Congress has listened to these "danger of delay" arguments[19] and **[16]** nevertheless determined that such burdens must be borne, in order that the government get timely information on the other mergers which may be anticompetitive.

Prior approval, in a case of this nature, is precisely the sort of relief that is needed to accomplish the prophylactic aims of Section 7 of the Clayton Act. Neither the Department of Justice nor the Federal Trade Commission has resources or time enough to proceed case-by-case in dealing with a merger wave, unless one fruit of such litigation is some legally established curb over potentially anticompetitive future merger activity.[20] The Commission's failure to enter prior approval relief here lends unnecessary strength to those who criticize existing law and existing law enforcers for insufficient efforts to deal with anticompetitive merger-related increases in market power. It strains credulity, when, in the past 20 years prior approval relief has been directed in over 90% of final Section 7 orders, to believe that this case falls somewhere short of the mark.

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[19] Several of AMI's arguments against government supervision of merger activity are virtually identical to those made in the 1950s and 1960s by witnesses testifying against the earliest forms of legislation that eventually resulted in the present Hart-Scott-Rodino premerger reporting program. In particular, an officer of the American Bar Association predicted that delays in complying with premerger notification requirements would "kill" procompetitive and lawful acquisitions. *See*, testimony of James A. Sprunk, Hearings on H.R. 2882, H.R. 3563, H.R. 6058 and H.R. 6698 before the Antitrust Subcomm. of the House Comm. on the Judiciary, 87th Cong., 1st Sess., 219,230–237 (1961).

[20] "The proper disposition of antitrust cases is obviously of great public importance, and their remedial phase, more often than not, is crucial. For the suit has been a futile exercise if the Government proves a violation but fails to secure a remedy adequate to redress it." *U.S. v. E.I. du Pont de Nemours*, 366 U.S. 316, 323 (1961).

FINAL ORDER

I

This matter has been heard by the Commission upon the appeal of Respondents from the Initial Decision, and upon briefs and oral argument in support of and in opposition to the appeal. For the reasons stated in the accompanying opinion, the Commission has determined to affirm in part and reverse in part the Initial Decision. Accordingly, the Commission enters the following Order.

Definitions

It is ordered, That for purposes of this Order the following definitions shall apply:

A. *Acquire any hospital* means to directly or indirectly acquire all or any part of the stock or assets of any hospital, or enter into any arrangement by which AMI obtains ownership, management, or control of any hospital, including the right to lease or manage any hospital. [2]

B. *AMI* means American Medical International, Inc., a corporation organized under the laws of Delaware with its principal executive offices at 414 North Camden Drive, Beverly Hills, California, and its directors, officers, agents, and employees, and its subsidiaries, divisions, affiliates, successors, and assigns.

C. *AMISUB (French Hospital)* means the wholly-owned subsidiary corporation of AMI that was established for the purpose of acquiring and operating French Hospital located in San Luis Obispo, California.

D. *County* also means a county equivalent such as a parish in Louisiana.

E. *General acute care hospital,* herein referred to as *hospital(s),* means a health facility, other than a federally-owned facility, having a duly organized governing body with overall administrative and professional responsibility and an organized professional staff that provides 24-hour inpatient care, and whose primary function is to provide inpatient services for medical diagnosis, treatment, and care of physically injured or sick persons with short-term or episodic health problems or infirmities.

F. *Operate a hospital* also means to own, manage or lease a general acute care hospital.

G. *MSA* and *PMSA* mean, respectively, a Metropolitan Statistical Area and a Primary Metropolitan Statistical Area, as defined as of July 1, 1983 by the Office of Management and Budget, Office of Information and Regulatory Affairs.

II

It is ordered, That within twelve (12) months from the date this Order becomes final, AMI shall divest, absolutely and in good faith, all stock, assets, properties, licenses, leases, and other rights and privileges, tangible and intangible, that AMI acquired from Central Coast Hospital Company, French Hospital [3] Corporation and French Medical Clinic, Inc., together with any subsequent improvements. The purpose of the divestiture is to reestablish French Hospital as a viable competitor in San Luis Obispo County. The divestiture shall be subject to the prior approval of the Federal Trade Commission.

Pending divestiture, AMI shall take all measures necessary to maintain French Hospital in its present condition and to prevent any deterioration, except for normal wear and tear, of any of the assets to be divested so as not to impair French Hospital's present operating abilities or market value.

III

It is further ordered, That for a period of ten (10) years from the date this Order becomes final, AMI shall not, without providing advance notification to the Federal Trade Commission, directly or indirectly acquire any hospital located in the states of Oregon, California, Texas, Oklahoma, Missouri, Arkansas, Louisiana, Mississippi, Alabama, Georgia, Florida, South Carolina, or North Carolina, if:

A. The hospital to be acquired is within an MSA or a PMSA in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a twenty (20) percent or more share of the licensed general acute care hospital beds within that MSA or PMSA; or

B. The hospital to be acquired is not within an MSA or a PMSA but is within a county in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a [4] twenty (20) percent or more share of the licensed hospital beds within that county; or

C. The hospital to be acquired is (1) not within an MSA or a PMSA or a county in which AMI already operates a hospital, but is within thirty (30) miles of a hospital which AMI already operates in another MSA or PMSA or county, and (2) the hospital to be acquired and any hospital(s) that AMI operates combined have a twenty (20) percent or more share of the licensed hospital beds in the area within thirty (30) miles of the midpoint between the hospital to be acquired and any hospital operated by AMI.

Provided, however, That no acquisition shall be subject to this Section III if the consideration to be paid for the purchase of the hospital, including assumption by AMI of liabilities of its present owners, does not exceed one million dollars ($1,000,000).

Such advance notification shall be provided when AMI's Board of Directors or Executive Committee authorizes issuance of a letter of intent or enters into a purchase agreement to make such an acquisition, whichever is earlier.

IV

It is further ordered, That AMI shall, within sixty (60) days after the date this Order becomes final and every sixty (60) days thereafter until it has fully complied with the provisions of Section II of this Order, submit a report in writing to the Federal Trade Commission setting forth in detail the manner and form in which it intends to comply, is complying, and has complied with these provisions.

Such compliance reports shall include a summary of all contacts and negotiations with potential purchasers of the stock [**5**] and assets to be divested under this Order, the identity and address of all such potential purchasers, and copies of all written communications to and from such potential purchasers.

AMI also shall submit such further written reports as the staff of the Federal Trade Commission may from time to time request in writing to assure compliance with this Order.

V

It is further ordered, That AMI shall notify the Federal Trade Commission at least thirty (30) days prior to any proposed corporate change, such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries, or any other change in the corporation that may affect compliance with the obligations arising out of this Order.

Commissioners Pertschuk and Bailey concurred in part and dissented in part.

IN THE MATTER OF

TEXACO INC. and GETTY OIL COMPANY

CONSENT ORDER, ETC. IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 7 OF THE CLAYTON ACT

Docket C-3137. Complaint, July 10, 1984—Decision, July 10, 1984

This Consent Order requires Texaco Inc., among other things, to divest within 12 months to a Commission-approved purchaser, all the Getty assets and properties listed in Schedule A (excluding the assets listed in Schedule C). Should Texaco fail to timely divest the Schedule A properties, a trustee appointed by the court or the Commission will have 18 months in which to effect divestiture of the remaining assets. Until such time as the specified properties have been divested, Texaco is required to maintain their viability and marketability, and hold them separate and apart in accordance with the terms and provisions set forth in the Order. Texaco is further required, for a period of ten years, to take the following actions: 1) vote its shares in favor of any proposal to increase the capacity or enhance the ability of the Colonial Pipeline Company to transport refined product north of Dorsey Junction, Maryland; 2) offer Getty customers using the Getty pipeline from Santa Fe Springs to Los Angeles in 1983 access to that pipeline under the 1983 terms and conditions; and 3) refrain from acquiring, without prior Commission approval, any concern engaged in the refining or wholesale distribution of gasoline or middle distillates in certain states or in transporting any petroleum product by pipeline in or into Colorado. Additionally, for a period of five years, Texaco is required to sell to customers of Getty in 1983 (excluding 10 major oil companies), and to other West Coast refiners, California crude oil of similar grade and quality to that sold in 1983 on the contractual terms listed in Schedule B.

Appearances

For the Commission: *Marc G. Schildkraut.*

For the respondents: *William C. Weitzel, Jr.* and *C. Benjamin Crisman, Jr.*, in-house counsel, White Plains, N.Y., for respondent Texaco Inc. and *Jack Leone,* Los Angeles, Ca., for respondent Getty Oil Co.

COMPLAINT

The Federal Trade Commission, having reason to believe that respondent, Texaco Inc., a corporation subject to the jurisdiction of the Federal Trade Commission, intends to acquire, or has acquired the stock or assets of respondent Getty Oil Company, in violation of Section 7 of the Clayton Act, as amended (15 U.S.C. 18), and Section 5 of the Federal Trade Commission Act, as amended (15 U.S.C. 45), and that a proceeding in respect thereof would be in the public interest, hereby issues its complaint, pursuant to Section 11 of the Clayton Act

(15 U.S.C. 21) and Section 5(b) of the Federal Trade Commission Act (15 U.S.C. 45(b)), stating its charges as follows:

I. Definitions

1. For purposes of this complaint, the following definitions shall apply:

a. *Texaco* means Texaco Inc., its predecessors, subsidiaries, divisions, groups, affiliate entities, and each of their past or present directors, officers, employees, agents and representatives; and each partnership, joint venture, joint stock company or concession in which Texaco is a participant. The words *subsidiary, affiliate* and *joint venture* refer to any partial (10 percent or more) as well as total ownership or control.

b. *Getty* means Getty Oil Company, its predecessors, subsidiaries, divisions, groups, affiliate entities, and each of their past or present directors, officers, employees, agents and representatives; and each partnership, joint venture, joint stock company or concession in which Getty is a participant. The words *subsidiary, affiliate* and *joint venture* refer to any partial (10 percent or more) as well as total ownership or control.

c. *The acquisition* means the transaction described, in whole or in part, in paragraph 14 of this Complaint.

d. *Aviation gasoline* means that product as defined in connection with Department of Energy Form EIA-810, Monthly Refinery Report, product code 111.

e. *Gasoline* means motor gasoline as defined in connection with Department of Energy Form EIA-810, Monthly Refinery Report, product codes 132 and 133.

f. *Jet fuels* means naptha-type and kerosene-type jet aircraft fuel, as defined in connection with Form EIA-810, Monthly Refinery Report, product codes 211 and 213.

g. *Middle distillates* means the products commonly known as number one fuel oil (kerosene), and number two fuel oil (home heating, diesel), as defined in connection with Department of Energy Form EIA-810, Monthly Refinery Report, product codes 311 and 411.

h. *Refined light products* means aviation gasoline, gasoline, jet fuels, and middle distillates.

i. *Heavy crude oil* means crude oil below 20 API gravity.

j. *Terminal* means a facility used for receipt, storage, and distribution of gasoline, middle distillates, or jet fuel, and which receives product directly via pipeline, navigable waterway or from an adjacent refinery.

II. Respondents

A. *Texaco*

2. Respondent Texaco is a corporation organized and doing business under the laws of the state of Delaware with its executive offices at White Plains, New York.

3. Respondent Texaco is a fully integrated petroleum company, engaged in the exploration for and production of crude oil and natural gas, refining, the transportation of crude oil, natural gas and refined products, and the distribution and marketing of refined products and natural gas.

4. In 1982, respondent Texaco had revenues of about $48 billion, assets of about $27 billion, and net income of about $1.28 billion.

5. In 1982, respondent Texaco ranked sixth in the United States in crude oil production, eighth in domestic crude oil reserves, fifth in refining capacity, and fourth in gasoline sales.

6. Respondent Texaco has refineries located at Wilmington, California; Lawrenceville, Illinois; Convent, Louisiana; Westville, New Jersey; Port Arthur, Texas; Port Neches, Texas; Amarillo, Texas; El Paso, Texas; and Anacortes, Washington, with a combined refining capacity of 937 thousand barrels per day. In 1982, Texaco sold its refineries in West Tulsa, Oklahoma and shut down its refinery in Casper, Wyoming.

7. At all times relevant herein, respondent Texaco has been and is now engaged in commerce as "commerce" is defined in Section 1 of the Clayton Act, as amended, 15 U.S.C. 12, and is a corporation whose business is in or affecting commerce as "commerce" is defined in Section 4 of the Federal Trade Commission Act, as amended, 15 U.S.C. 44.

B. *Getty*

8. Respondent Getty is a corporation organized and doing business under the laws of the state of Delaware with its executive offices at Los Angeles, California.

9. Respondent Getty is a fully integrated petroleum company, engaged in the exploration for and production of crude oil and natural gas, refining, the transportation of crude oil, natural gas and refined products, and the distribution and marketing of refined products and natural gas.

10. In 1982, respondent Getty had revenues of about $12.3 billion, assets of about $9.9 billion, and net income of about $692 million.

11. In 1982, respondent Getty ranked 10th nationally in crude oil production, 6th in United States crude oil reserves, 18th in United States refining capacity, and 16th in United States motor gasoline sales.

12. Respondent Getty has refineries located at Bakersfield, California; Delaware City, Delaware; and El Dorado, Kansas, with a combined refining capacity of about 278 thousand barrels per day.

13. At all times relevant herein, respondent Getty has been and is now engaged in commerce as "commerce" is defined in Section 1 of the Clayton Act, as amended, 15 U.S.C. 12, and is a corporation whose business is in or affecting commerce as "commerce" is defined in Section 4 of the Federal Trade Commission Act, as amended, 15 U.S.C. 44.

III. The Acquisition

14. On January 9, 1984, Texaco commenced a tender offer for 35 percent of Getty voting securities with the intention of effectuating a follow-up merger for the remaining outstanding shares; and on January 6, 1984, Texaco and Getty entered into a merger agreement pursuant to which Getty granted Texaco an option to purchase authorized but unissued shares constituting approximately 10.2 percent of the total Getty shares that would be outstanding after such issuance. Further, on or about January 6, 1984, and January 8, 1984, Texaco entered into agreements to purchase voting securities constituting approximately 11.8 percent and 40.2 percent, respectively, of the outstanding Getty shares. The total value of the transaction is about $10.1 billion and, if consummated, would result in the second largest petroleum company in the United States in terms of assets.

IV. Trade and Commerce

A. *Manufacture of Refined Light Products in the Northeast United States*

15. One relevant line of commerce in which to evaluate the effects of the acquisition is the manufacture of refined light products.

16. The relevant section of the country is the Northeast region, composed of Maryland, Delaware, eastern Pennsylvania, New Jersey, eastern New York, Connecticut, Rhode Island, Massachusetts, New Hampshire, Vermont and Maine, and any submarket thereof. This relevant section of the country also includes the United States possession of the Virgin Islands.

17. The manufacture of refined light products in the relevant section of the country is moderately concentrated.

18. Respondents Texaco and Getty are actual competitors of each other and of other firms in the manufacture of refined light products in the relevant section of the country. Respondent Texaco owns a refinery in Westville, New Jersey, that manufactures refined light products. Respondent Getty owns a refinery in Delaware City, Delaware, that manufactures refined light products.

19. Refineries in the Northeast region have a locational advantage over Gulf Coast refineries in the supply of refined light products to the relevant section of the country.

20. Refineries in the Gulf Coast area are unlikely to be able to expand substantially, and within a reasonable period of time, shipments of refined light products to the relevant section of the country on Colonial Pipeline due to the likelihood of capacity constraints on the pipeline.

21. Foreign imports of refined light product into the relevant section of the country are unlikely within a reasonable period of time to provide substantial competition to the manufacturers of refined light product in the relevant section of the country.

22. Conditions of entry into the manufacture of refined light products in the relevant section of the country are difficult.

23. Texaco's incentives concerning the level of prices and outputs of refined light products in the relevant section of the country are affected by Texaco's share of refining capacity in the Northeast region. Texaco's share of refined light product supply into the Northeast region, Texaco's ownership share of Colonial Pipeline, and Texaco's level of shipments into the Northeast region on Colonial Pipeline.

B. *Transportation of Refined Light Products*

24. One relevant line of commerce in which to evaluate the effects of the acquisition is long distance transportation of refined light petroleum products into consuming regions. Within this market, petroleum product pipelines represent another relevant line of commerce.

25. One relevant section of the country is the Northeast region composed of Maryland, Delaware, eastern Pennsylvania, New Jersey, eastern New York, Connecticut, Rhode Island, Massachusetts, New Hampshire, Vermont, and Maine.

26. Another relevant section of the country is the State of Colorado.

27. Transportation of refined petroleum products into the relevant sections of the country is highly concentrated.

28. Refinery capacity for refined light products in the State of

Colorado is not adequate to meet demand and substantial amounts of refined light products are transported into the State of Colorado.

29. There are four pipelines capable of transporting refined light products into the State of Colorado: The Wyco Pipe Line; The Medicine Bow Products Pipeline System; the Chase Pipe Line; and a pipeline owned by Phillips and Diamond Shamrock that runs from Borger, Texas, to Aurora, Colorado, near Denver.

30. The Wyco Pipe Line is jointly owned by Texaco (40 percent), Amoco (40 percent), and Mobil (20 percent). The South Line of the Wyco Pipe Line runs from Cheyenne, Wyoming, through Denver, Colorado, and terminates in Colorado Springs, Colorado.

31. The Chase Pipe Line is owned by Getty (50 percent) and Koch Oil Company (50 percent). It runs from El Dorado, Kansas to the Denver, Colorado area.

32. Texaco's incentives with respect to the level of tariffs on the Wyco Pipe Line and Chase Pipe Line are affected by Texaco's ownership share of pipelines capable of transporting refined light product into the State of Colorado.

33. Refinery capacity for refined light products in the Northeast region is not adequate to meet demand for refined light products in this relevant section of the country. The Colonial Pipeline is the dominant means of transporting additional refined light products into the Northeast region, supplying approximately 36.9 percent of total consumption of refined light products in the relevant section of the country in 1982. Four firms (Texaco, Gulf, Amoco, and CITGO Pipeline Investment Company) account for approximately 59.35 percent of ownership of the Colonial Pipeline.

34. Conditions of entry into the business of the transportation of refined light products by pipeline into the relevant sections of the country are difficult.

35. Respondents Texaco and Getty are actual competitors of each other and of other firms in the transportation of refined light products in the Northeast region. Respondent Texaco holds an ownership share of about 14.3 percent of the Colonial Pipeline. Respondent Getty owns 100 percent of the Getty Eastern Products Pipeline.

36. Tariff rates on the Colonial Pipeline are set by action of the Colonial Board of Directors.

37. Texaco's incentives concerning the level of tariffs on the Colonial Pipeline and expansion of the Colonial Pipeline are affected by Texaco's ownership share of Colonial Pipeline, Texaco's level of shipments on the Colonial Pipeline, Texaco's refining capacity in the Northeast region, and Texaco's share of petroleum product supply in the Northeast region.

C. *Marketing of Gasoline and Middle Distillate*

38. One relevant line of commerce in which to evaluate the effects of the acquisition is the wholesale distribution of gasoline and middle distillate and submarkets thereof.

39. The relevant sections of the country are the areas served by terminal clusters in or near the following cities and areas:

a. New Haven, Connecticut
b. Portland, Maine
c. New York City, New York
d. the Delaware River Valley
e. Providence, Rhode Island
f. Colorado Springs, Colorado
g. the Delmarva Peninsula.

40. The wholesale gasoline and middle distillate markets described in paragraphs 38 and 39 are concentrated with substantial shares of wholesale gasoline and middle distillate sales in each of the relevant sections of the country accounted for by respondents Texaco and Getty.

41. Conditions of entry into the wholesale distribution of gasoline and middle distillate are difficult.

42. Respondents Texaco and Getty are actual competitors of each other and of other firms in the wholesale distribution of gasoline and middle distillate in the relevant sections of the country. The combination of Texaco and Getty would increase the levels of concentration and combine their shares in the relevant sections of the country.

43. Texaco's incentives concerning the level of prices and output of gasoline and middle distillate sold from terminals and the price of and access to available terminal facilities are affected by Texaco's share of terminal capacity within each terminal cluster.

D. *Sale, Transportation and Refining of California Heavy Crude Oil into Petroleum Products*

44. One relevant line of commerce in which to evaluate the effects of the acquisition is the sale of heavy crude oil.

45. Another relevant line of commerce in which to evaluate the effects of the acquisition is the transportation of crude oil through pipelines including trunk lines and gathering lines.

46. For the sale and transportation of crude oil, one relevant section of the country is the State of California.

47. Another relevant line of commerce in which to evaluate the effects of the acquisition is the refining of crude oil into petroleum products.

48. For the refining of crude oil into petroleum products, one rele-

vant section of the country is the West Coast of the United States, extending from the State of California to the State of Washington.

49. Concentration in the relevant markets is high and entry conditions are difficult.

50. Both Getty and Texaco own refineries in the relevant market. Getty owns a refinery in Bakersfield, California. Texaco owns a refinery in Wilmington, California and Anacortes, Washington.

51. Getty produces substantially more heavy crude oil than it can refine on the West Coast.

52. Texaco produces substantially less heavy crude oil than it can refine on the West Coast.

53. Texaco owns and operates a proprietary pipeline system to gather heavy crude oil in the San Joaquin Valley of California.

54. Getty owns and operates a proprietary pipeline system that gathers heavy crude oil in the San Joaquin Valley and transports heavy crude oil from Bakersfield to the San Francisco area.

55. Texaco's West Coast refineries compete with the refineries of non-integrated refiners.

56. Texaco has an incentive to increase its refining of heavy crude oil and to lessen competition from non-integrated refiners.

57. The acquisition of Getty is likely to increase Texaco's incentives and ability to deny non-integrated refiners heavy crude oil and access to proprietary pipelines.

V. Effects

58. The effect of the acquisition may be substantially to lessen competition or tend to create a monopoly in each of the relevant lines of commerce and relevant sections of the country in violation of Section 7 of the Clayton Act, as amended, 15 U.S.C. 18, and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. 45, in the following ways, among others:

a. actual competition between respondents Texaco and Getty in the relevant lines of commerce and relevant sections of the country will be eliminated; and

b. actual competition between competitors generally in the relevant lines of commerce and relevant sections of the country will be lessened.

59. The effect of the acquisition may be substantially to lessen competition or tend to create a monopoly in the relevant lines of commerce and relevant sections of the country in violation of Section 7 of the Clayton Act, as amended, 15 U.S.C. 18, and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. 45, in the following additional ways, among others:

a. Texaco may have the incentive and ability to and may raise price levels and restrict output of refined light products from its Northeast region refining capacity because the acquisition increases Texaco's share of refining capacity in and pipeline capacity into the Northeast region, and increases Texaco's share of refined light product supply in the Northeast region.

b. Texaco may be likely to support and secure a higher level of tariffs on the Colonial Pipeline and oppose expansion of the Pipeline because the acquisition increases Texaco's refining capacity in the Northeast, increases Texaco's share of petroleum product supply in the Northeast, and decreases Texaco's relative shipment requirements on the Colonial Pipeline.

c. Texaco may be likely to support and secure a higher level of tariffs on the Wyco Pipe Line and Chase Pipe Line because the acquisition increases Texaco's share of pipeline capacity in the State of Colorado and increases its share of refined light product supply in the State of Colorado.

d. Control by Texaco of Getty's marketing operations is likely to reduce price competition in gasoline and middle distillate marketing provided by Getty and by independent private brand marketers previously supplied by Getty in the relevant sections of the country.

e. Texaco may have the incentive and ability to and may raise price levels and restrict output from gasoline and middle distillate terminals and raise the level of price and limit access to available terminal facilities in certain terminal clusters because the acquisition will increase Texaco's share of terminal capacity in these terminal clusters.

f. For reasons unrelated to the efficient use of resources, Texaco may have the incentives and ability to and may deny access to heavy crude oil and to proprietary pipeline transportation to non-integrated refiners, thereby increasing the difficulty of entry into West Coast refining, decreasing the competitive significance of non-integrated West Coast refiners, and increasing concentration in West Coast refining.

VI. Violation Charged

60. The proposed acquisition of the stock and assets of Getty by Texaco, as set forth in paragraph 14 herein, if consummated, would violate Section 7 of the Clayton Act, as amended, 15 U.S.C. 18, and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. 45.

Commissioner Pertschuk dissented.

DECISION AND ORDER

The FTC having initiated an investigation of the proposed acquisition of shares of Getty Oil Company ("Getty") by Texaco Inc. ("Texaco"), and Texaco having been furnished with a copy of a draft complaint that the Bureau of Competition has presented to the Commission for its consideration, and which, if issued by the Commission would charge Texaco and Getty with violations of the Clayton Act and Federal Trade Commission Act; and

Respondent Texaco, its attorneys, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by respondent Texaco of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondents that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having considered the matter and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, and having duly considered the comments filed thereafter by interested persons pursuant to Section 2.34 of its Rules and the recommendation of its staff, and having concluded that the consent agreement should be modified along the lines suggested by staff, with changes; and

Respondent Texaco and complaint counsel having thereafter executed and submitted a revised agreement containing consent order dated July 9, 1984, containing modifications agreed to by the Commission; and

The executed agreement dated July 9, 1984, as modified, containing the following consent order, an admission by respondent Texaco of all the jurisdictional facts set forth in the complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondents that the law has been violated as alleged in the complaint, and waivers as required by the Commission's Rules;

Now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby makes the following jurisdictional findings and enters the following order:

1. Respondent Texaco Inc. is a corporation organized, existing and doing business under and by the virtue of the laws of Delaware with its executive office located at 2000 Westchester Avenue, White Plains, New York.

2. Respondent Getty Oil Company, a wholly owned subsidiary of

Texaco, is a corporation organized and doing business under and by virtue of the laws of Delaware, with its executive office at 3810 Wilshire Boulevard, Los Angeles, California.

3. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondents, and the proceeding is in the public interest.

ORDER

I.

As used in this order the following definitions shall apply:

(a) the *Acquisition* means Texaco's acquisition of the common stock of Getty.

(b) *Schedule A Properties* means the assets and businesses listed in Schedule A of this Order.

(c) *Getty* means Getty Oil Company, as it was constituted prior to the acquisition, including its parents, predecessors, subsidiaries, divisions, groups, affiliate entities, and their directors, officers, employees, agents and representatives, and their successors and assigns.

(d) *Texaco* means Texaco Inc., its predecessors, subsidiaries, divisions, groups, affiliate entities, and their directors, officers, employees, agents and representatives, and their successors and assigns.

II.

It is ordered, That:

(A) Within 12 months of the date of service of this order, Texaco shall divest, absolutely and in good faith, the Schedule A properties.

(B) Divestiture of the Schedule A properties shall be made only to an acquirer or acquirers, and only in a manner, that receive the prior approval of the Federal Trade Commission. The purpose of the divestiture of the Schedule A properties is to ensure the continuation of the assets as ongoing, viable enterprises, engaged in the same business in which the properties are presently employed and to remedy the lessening of competition resulting from the Acquisition as alleged in the Commission's complaint.

(C) If Texaco has not divested the Schedule A properties within the 12-month period, Texaco shall consent to the appointment of a trustee in any action that the Federal Trade Commission may bring pursuant to Section 5(l) of the Federal Trade Commission Act, 15 U.S.C. 45(l), or any other statute enforced by the Commission. In the event the court declines to appoint a trustee, Texaco shall consent to the appointment of a trustee by the Commission pursuant to this order. The appointment of a trustee shall not preclude the Commission from seeking civil penalties and other relief available to it for any failure by Texaco to comply with paragraphs II(C) through IX of this order.

(D) If a trustee is appointed by a court or the Commission pursuant to Paragraph II(C) of this order, Texaco shall consent to the following terms and conditions regarding the trustee's duties and responsibilities:

1. The Commission shall select the trustee, subject to Texaco's consent, which shall not be unreasonably withheld. The trustee shall be a person with experience and expertise in acquisitions and divestitures.

2. The trustee shall have the power and authority to divest any Schedule A properties that have not been divested by Texaco within the time period for divestiture in paragraph II(A). The trustee shall have 18 months from the date of appointment to accomplish the divestiture, which shall be subject to the prior approval of the Commission and if the trustee was appointed by a court, subject also to the prior approval of the court. If, however, at the end of the 18-month period the trustee has submitted a plan of divestiture or believes that divestiture can be achieved within a reasonable time, the divestiture period may be extended by the Commission or by the court, if the trustee was appointed by a court.

3. The trustee shall have full and complete access to the personnel, books, records and facilities of any business that the trustee has the duty to divest, and Texaco shall develop such financial or other information relevant to the assets to be divested as such trustee may reasonably request. Texaco shall cooperate with the trustee, and shall take no action to interfere with or impede the trustee's accomplishment of the divestiture.

4. The power and authority of the trustee to divest shall be at the most favorable price and terms available consistent with the order's absolute and unconditional obligation to divest and the purposes of the divestiture as stated in paragraph II(B).

5. The trustee shall serve at the cost and expense of Texaco on such reasonable and customary terms and conditions as the Commission or a court may set. The trustee shall account for all monies derived from the sale and all expenses incurred. After approval by the court or the Commission of the account of the trustee, including fees for his or her services, all remaining monies shall be paid to Texaco and the trustee's power shall be terminated. The trustee's compensation shall be based at least in significant part on a commission arrangement contingent on the trustee divesting the trust property.

6. Promptly upon appointment of the trustee and subject to the approval of the Commission, Texaco shall, subject to the Commission's prior approval and consistent with provisions of this order, execute a trust agreement that transfers to the trustee all rights and powers necessary to permit the trustee to cause divestiture.

7. If the trustee ceases to act or fails to act diligently, a substitute trustee shall be appointed.

8. The trustee shall report in writing to Texaco and the Commission every sixty (60) days concerning the trustee's efforts to accomplish divestiture.

(E) Texaco shall maintain the viability and marketability of the Schedule A properties and shall not cause or permit the destruction, removal or impairment of any assets or businesses to be divested except in the ordinary course of business and except for ordinary wear and tear.

(F) Until such time as the Schedule A(1) assets have been divested, Texaco shall continue to hold the Getty assets in Schedule A(1) separate and apart in a subsidiary or subdivision on the following terms and conditions:

1. Texaco shall not exercise direction or control over, or influence directly or indirectly, the day-to-day operations or personnel of the subsidiary or subdivision except as necessary to comply with this order;

2. Except as required by law and except to the extent that necessary information is exchanged in the course of evaluating the Acquisition, defending litigation or negotiating agreements to dispose of assets, Texaco shall not have access to any material confidential information relating to the subsidiary's or subdivision's operations not in the public domain. "Material confidential information" as used herein means competitively sensitive or proprietary information not independently known to Texaco from sources other than from the subsidiary or subdivision, and includes, but is not limited to, customer lists, price lists, price information, price zones, marketing methods, patents, technologies, processes, or other trade secrets.

(G) Until such time as the Schedule A(2)(a) or (b) assets have been divested, Texaco shall not exercise direction or control over, influence directly or indirectly, or exercise any voting rights with respect to the Wyco Pipe Line.

III.

It is further ordered, That, within (60) days after the date of service of this order, and every sixty (60) days thereafter until Texaco has fully complied with the provisions of Paragraph II of this order, Texaco shall submit to the Federal Trade Commission a verified written report setting forth in detail the manner and form in which it intends to comply, is complying with, or has complied with that provision. Texaco shall include in compliance reports, among other things that are required from time to time, a full description of contacts or negotiations for the divestiture of properties specified in paragraph II of this order, including the identity of all parties contacted. Texaco also shall include in its compliance reports copies of all written communications to and from such parties, and all internal memoranda, reports, and recommendations concerning divestiture.

IV.

It is further ordered, That, for ten (10) years following the date that this order shall become final, Texaco shall support, vote in favor of and take no action to impede any and all proposals and actions (including placing the matter on agenda for discussion, study proposals, feasibility studies, or engineering studies) that have been made or supported by any owner of an interest in the Colonial Pipeline Company to expand, extend, or otherwise increase the capacity of the Colonial Pipeline north of Dorsey Junction, Maryland or otherwise to increase or enhance the ability of the Colonial Pipeline to transport refined product north of Dorsey Junction, Maryland.

V.

It is further ordered, That Texaco sell California crude oil of similar grade and quality to that sold by Getty in 1983 to each Eligible Purchaser in accordance with the terms and conditions listed in Schedule B.

VI.

It is further ordered, That, for ten (10) years following the date that this order shall become final, Texaco shall offer access to Getty's pipeline from Santa Fe Springs to Los Angeles to any Getty customer using the pipeline in 1983 in accordance with the terms and conditions in effect in 1983. Transportation fees shall be the fees levied for Getty's most recent arrangement in effect in December 1983 for comparable transportation, adjusted for the "Fuels and Related Products and Power Index," as published in "Producer Prices and Price Index," U.S. Department of Labor, Bureau of Labor Statistics. Any disputes between Texaco and any customer shall be settled by arbitration. If the parties are unable to agree on an arbitrator, the dispute shall be settled pursuant to the Commercial Arbitration Rules of the American Arbitration Association. The decision of the arbitrator shall be final and binding upon the parties and judgment thereupon may be entered in any court of competent jurisdiction. A violation by Texaco of any order of the arbitrator shall be a violation of this order.

VII.

It is further ordered, That for a period commencing on the date of service of this order and continuing for ten (10) years from and after the date of service of this order, Texaco shall cease and desist from acquiring, without the prior approval of the Federal Trade Commission, directly or indirectly, through subsidiaries or otherwise, assets used or previously used in (and still suitable for use in), any interest in, or the whole or any part of the stock, or share capital of any company that is engaged in:

(A) refining or the wholesale distribution of gasoline or middle distillates (including terminals and bulk plants) in Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania, Delaware, Maryland, West Virginia, or the District of Columbia; or

(B) any petroleum product pipeline transportation in or into Colorado.

Provided, however, these prohibitions shall not relate to the construction of new facilities or participation in joint ventures in which Texaco is a participant on the date of service of the order.

One year from the date of service of this order and annually thereafter Texaco shall file with the Commission a verified written report of its compliance with this paragraph.

VIII.

For the purpose of determining or securing compliance with this order, and subject to any legally recognized privilege, upon written request and on reasonable notice to Texaco made to its principal office, Texaco shall permit any duly authorized representatives of the Commission:

(A) Access during the office hours in the presence of counsel, to inspect and copy all books, ledgers, accounts, correspondence, memoranda, and other records and documents in the possession or under the control of Texaco relating to any matters contained in this order; and

(B) Upon five days notice to Texaco and without restraint or interference from them, to interview officers or employees of respondents, who may have counsel present, regarding any such matters.

IX.

It is further ordered, That Texaco notify the Commission at least thirty (30) days prior to any proposed change in the corporation such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change that may affect compliance obligations arising out of the order.

Commissioner Pertschuk dissented.

Schedule A

Schedule of Assets and Operations

1. Getty's petroleum-related assets, including the "Getty" brand name, "Getty" trademark, and product inventories located in Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania, Delaware, Maryland, West Virginia, and the District of Columbia, other than the Getty refinery located in Delaware and the Getty inventories, crude handling facility, product pipeline, and terminal connected to the refinery, and 30 of the properties listed in Schedule C. Texaco's terminal facility near Salisbury, Maryland. Texaco's Eagle Point Refinery (Westville, N.J.), including any crude handling facilities, terminals, inventories, or wholly-owned pipelines connected to the refinery. (The assets in this Paragraph, A(1), need not be divested as one package unless the Commission should so require in accordance with the terms of Paragraph II B of this Order.)

2. Either

a. Texaco's interest in the Wyco Pipe Line, or

b. The Getty Refining and Marketing Company's El Dorado, Kansas refinery and inventories, as well as related feedstock pipelines and terminals including Getty's interest in the Conway, Kansas storage facility and related terminals and pipelines; Osage Pipeline Co.; Boyer terminal, the Oklahoma-Kansas portion of Getty Pipeline, Inc. and Getty Crude Gathering, Inc.; the Cushing Crude Terminal; and the natural gas pipeline serving the refinery owned by Getty Gas Gathering, Inc. In addition, the Getty Refining and Marketing Company's marketing, sales and transportation assets, inventories, and the "Skelly" and "Surfco" brand names and trademarks for use in the sale of gasoline and middle distillate, in: Colorado, Illinois, Indiana, Iowa, Kansas, Minnesota, Michigan, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota, Wisconsin, Wyoming and Texas and Getty's ownership interest in the Chase Transportation Company and the Chase Terminal Co. and any other product pipelines connected to the El Dorado refinery.

Schedule B

Terms and Conditions

1. *Eligible Purchasers*—Texaco shall offer California crude oil on the contractual terms and conditions set out below, to the following entities:

(a) all purchasers of California crude oil from Getty in 1983 except Atlantic Richfield Co., British Petroleum Co., Chevron USA Inc., Exxon Co., Gulf Oil Co., Mobil Oil Corp., Phillips Petroleum Co., Shell Oil Co., Standard Oil Co. (Ohio), and Union Oil Co. and each of their affiliates, including affiliates acquired in whole or in part after the date that this order shall become final ("Excluded Companies");

(b) entities other than Excluded Companies that acquired Getty California crude oil (including crude oil obtained by Getty through production, acquisition or exchange) during 1983 from an Excluded Company under a contract of three months or more in duration (For the purposes of this provision and Paragraph B(5)(b), the acquisition of Getty California crude oil by an entity shall include any contractual arrangement for the receipt of a net volume of crude oil that confers on such entity the right to receive or to direct the sale, exchange or other disposition of Getty California crude oil to or by or through another);

(c) entities that have refineries located in PADD V and that had a total refining capacity worldwide of less than 100,000 barrels/day in December 1983.

Notwithstanding such offer Texaco and any Eligible Purchaser may agree to other terms and conditions.

2. *Term*—From the date of termination of the contract on which Texaco's supply obligation is based or from 45 days after the date that this Order shall become final, if no contract exists, until July 1, 1989, or such shorter term desired by the Eligible Purchaser.

3. *Price*—The maximum price shall be determined as follows:

(a) The arithmetic average of the prices posted for crude oil in the field where posted by any company that produced during the previous calendar year not less than 25,000 barrels/day of the crude oil produced in the state of California. *Provided, however,* that Texaco's posting shall not account for more than 25 percent in the average price.

(b) If one or more of the posters in a field, satisfying the criteria in Paragraph B(3)(a), above, except Texaco, shall post a price for crude oil in that field higher than the average for a period of at least ninety (90) consecutive days, then, commencing on the 91st day, the price shall be the highest price so posted for more than ninety (90) consecutive days. This price shall remain in effect so long as it remains highest. Thereafter the price shall revert to the price as determined by subparagraph (a).

(c) If there is no posted price for a crude oil in a field from which crude oil is sold, the price for that crude oil shall be the price determined in accordance with subparagraph (a) for similar crude oil from the nearest field in California, with adjustment for gravity in accordance with prevailing practice in the industry at the time and place.

4. *Delivery*—If appropriate based on the location of the crude oil and the desired destination of the Eligible Purchaser, through Getty's or Texaco's existing pipelines (directly or through normal and customary accommodations with competitors' pipeline transportation systems to the extent Getty or Texaco engaged in such accommodations in their past course of dealings and to the extent such accommodations remain available to Texaco) on conditions similar to conditions in December 1983. Transportation fees shall be the fees levied for Getty's most recent arrangement in effect in December 1983 for comparable transportation, adjusted for the "Fuels and Related Products and Power Index," as published in "Producer Prices and Price Index," U.S. Department of Labor, Bureau of Labor Statistics. *Provided, however,* that the fees may include a

reasonable return on any new investment to expand the capacity or extend the length of the pipelines.

5. *Volume per year*—

(a) Texaco shall offer to each Eligible Purchaser under Paragraph B(1)(a) the percentage set out in Paragraph B(5)(d) of the volume of California crude oil such purchaser acquired from Getty in 1983.

(b) Texaco shall offer to each Eligible Purchaser under Paragraph B(1)(b) the percentage set out in Paragraph B(5)(d) of the volume of Getty California crude oil such purchaser acquired from any Excluded Company in 1983. *Provided, however,* that Texaco may provide such volume under an existing contract to the extent the Eligible Purchaser has contracted with Texaco for net purchases of California crude oil. In the event of any such contract, Texaco shall offer to rescind such contract and substitute therefor a new contract pursuant to this order.

(c) If any Eligible Purchaser under Paragraph (B)(1)(a) and B(1)(b) should take less than the volume of crude oil that Texaco is required to offer, the Eligible Purchaser's future rights are proportionally reduced but Texaco shall make the volume not taken available for sale, under the terms and conditions set out herein, to Eligible Purchasers under Paragraph B(1)(c). *Provided, however,* Texaco shall not be required to prorate among all such Eligible Purchasers but may sell to any one or more of them so long as such volume is sold.

(d) In each year, Texaco shall apply the following percentage to determine the volume it must offer to each Eligible Purchaser under Paragraphs B(5)(a) and (b):

1984 - 81 percent
1985 - 83 percent
1986 - 86 percent
1987 - 90 percent
1988 - 100 percent
1989 - 100 percent.

6. *Exchanges and Buy-Sell Arrangements*—Texaco shall have no obligation to offer crude oil under Paragraph V and Schedule B of this order for any volume of crude oil acquired in 1983 from Getty or an Excluded Company through an exchange or buy-sell arrangement to the extent that no net sale of crude oil occurred.

7. *Resale*—Texaco shall not condition any sale under this order on any requirement for resale or exchange of any crude oil. *Provided, however,* that the parties may agree to exchanges or buy-sell arrangements that facilitate the delivery of crude oil and do not diminish the net volume sold, subject to normal pipeline differentials and volume allowances.

8. *Practicality*—Texaco shall not be required to deliver crude oil to the extent that Getty's production has ceased or been reduced in the course of normal operations below its 1983 level in California. *Provided, however,* any volumes not sold because production has ceased or been reduced shall be sold to the Eligible Purchaser on the same terms and conditions when production recommences, even after July 1, 1989.

9. *Arbitration*—Any dispute between Texaco and any party with a claim under Paragraph V and Schedule B of this order shall be settled by arbitration. In any case, where the application of the terms of Paragraph V and Schedule B is not clear, the arbitrator shall resolve disputes in a manner that satisfies the objectives of this order. If the parties are unable to agree on an arbitrator within thirty (30) days, the dispute shall be settled pursuant to the Commercial Arbitration Rules and the procedures of the American Arbitration Association. The decision of the arbitrator shall be final and binding upon the parties and judgment thereupon may be entered in any court of competent jurisdiction. A violation by Texaco of any order of the arbitrator shall be a violation of this order.

10. *Other*—The contract will be subject to force majeure and other customary terms to be negotiated, consistent with terms customary in the industry, including customary credit terms consistent with the terms that would be available to the Eligible Purchaser in an arm's-length purchase of crude oil. The contract may be subject to prospective prorationing to compensate for inconsistent arbitration decisions or arbitration awards for past violations of this order that would require Texaco to sell more than 100 percent of the volume that Texaco is required and has committed to sell under this order.

Schedule C

GETTY NORTHEAST PROPERTIES

Withheld Properties

1.	Massachusetts	–	1 Powder Mill Rd.	c/o	Maynard, MA.
2.			1060 Old Conn. Path	c/o	Framingham, MA.
3.			221 Main St.	c/o	Gardner, MA.
4.			245 N. Main St.	c/o	Randolph, MA.
5.			609 Park Ave.	c/o	Worcester, MA.
6.			671 Washington St.	co/LL	Quincy, MA.
7.			437 High Plain St.	L/b	Walpole, MA.
8.			835 Rockdale Ave.	c/o	New Bedford, MA.
9.			150 Plymouth Ave.	c/o	Fall River, MA.
10.			964 Boylston St.	c/o	Newton, MA.
11.			346 Sea St.	L/b	Quincy, MA.
12.	Connecticut	–	156 Boston Post Rd.	co/LL	Waterford, CT.
13.	Rhode Island	–	33 Jefferson Blvd.	c/o	Warwick, R.I.
14.			1307 Post Rd.	c/o	Warwick, R.I.
15.			1669 Warwick Ave.	c/o	Warwick, R.I.
16.			722 Willett Ave.	c/o	E. Providence, R.I.
17.			495 Tower Hill Rd.	c/o	E. Kingston, R.I.
18.			2501 W. Shore Rd.	L/B	Warwick, R.I.
19.	New York	–	1128 E. Gun Hill Rd.	co/LL	Bronx, N.Y.
20.			1133 Jerome Ave.	L/B	Bronx, N.Y.
21.			1740 Jerome Ave.	L/B	Bronx, N.Y.
22.			1881 Forest Ave.	c/o	Staten Island, N.Y.
23.			1124 First Ave.	L/B	New York, N.Y.
24.			1981 Ocean Ave.	L/B	Brooklyn, N.Y.
25.			920 Hylan Blvd.	L/B	Staten Island, N.Y.
26.			39-15 College Pt. Blvd.	L/B	New York, N.Y.
27.			152 10th Ave.	L/B	New York, N.Y.
28.			571 Coney Island Ave.	L/B	Brooklyn, N.Y.
29.	New Jersey	–	350 Preakness Ave.	c/o	Paterson, N.J.
30.			Rt. 30 - McLean Blvd.	c/o	Paterson, N.J.
31.			132 Rt. 46	c/o	Budd Lake, N.J.
32.			Rt. 9 & Locust St.	c/o	Lakewood, N.J.
33.			Rt. 88 (South Side)	c/o	Bricktown, N.J.
34.			551 W. Front St.	c/o	Plainfield, N.J.
35.			1650 Lincoln Hwy (Rt. 27)	c/o	Edison Twnp., N.J.

36.			1121 St. George Ave.	c/o	Woodbridge, N.J.
37.			Sicklerville & Andrews Rd.	co/LL	Winslow Twnp., N.J.
38.			2031 Rt. 22 (Westbd)	co/LL	Union, N.J.
39.			White Horse Pk & Franklin	co/LL	Berlin, N.J.
40.			48 French St.	co/LL	New Brunswick, N.J.
41.			Rt. 130 & Willow Dr.	L/b	Cinnaminson, N.J.
42.			County Line Rd.	L/b	Jackson Twp., N.J.
43.			Delsea Drive	L/b	Deptford Park, N.J.
44.			Rt. 20 North	L/b	Paterson, N.J.
45.			Rt. 35 & Poole Ave.	L/b	Hazlet, N.J.
46.			Rt. 22 (East)	L/b	Hillside, N.J.
47.			Middlesex & Main St.	L/b	Metuchen, N.J.
48.			2352 Morris Ave.	c/o	Union, N.J.
49.			Egg. Harbor Rd.	c/o	Washington, N.J.
50.			738 Cedar Lane	L/b	Teaneck, N.J.
51.			2284 Rt. #4	c/o	Fort Lee, N.J.
52.	Pennsylvania	–	Hunt Pk & Clearfield	c/o	Philadelphia, PA.
53.			6900 Frankford Rd.	c/o	Philadelphia, PA.
54.			Rt. 29 & Chestnut St.	c/o	Emmons, PA.
55.			3024 New Rogers Rd.	c/o	Bristol Twnp., PA.
56.			Albright & Tilghman	c/o	Allentown, PA.
57.			U.S. 202 & P.A. Trnpk.	c/o	King of Prussia, PA.
58.			Bustleton & Buck Rds.	c/o	Feasterville, PA.
59.	Maryland	–	121 South Bond St.	c/o	Bel Air, MD.
60.			149 Back River Rd.	c/o	Baltimore, MD.
61.			Oakleigh Rd.	L/b	Parkville, MD.

DISSENTING STATEMENT OF COMMISSIONER PERTSCHUK

Contrary to what appears to be prevailing Commission policy, Congress did not direct the antitrust agencies to strain the seams of the consent agreement-partial divestiture process to preserve massive mergers. We could have sued to enjoin this acquisition and we should have.

The final order as adopted by the majority has two major flaws. It fails to remedy a major competitive problem concerning independent refiners in California and instead creates a highly regulatory, incredibly complex and temporary crude supply program. Second, it fails to incorporate safeguards recently included in the *Socal/Gulf* agreement and, therefore, risks the ultimate unsuccessful divestiture and closing of assets which must be spun off under the order. [49 FR 23812, June 7, 1984]

The staff's theory concerning the west coast crude oil market is that Getty has been the largest supplier of heavy crude oil to non-integrated refiners in California. Texaco does not have the same incentives as Getty to supply independent refiners, in large part because of the Windfall Profits Tax, and, therefore, is more likely to divert crude to its own refinery system. Such a diversion would endanger the long run viability of refiners there and provide a means and added incentive for Texaco to attempt to acquire them at distress prices.

The Commission accepts this theory but opts for the inadequate remedy of requiring Texaco to supply crude oil for five years to independent refiners. This crude allocation scheme has become more complex between the initial and final versions of the order because of new questions about how to calculate price, volume, and related terms such as transportation and credit. The staff has done a good job under the circumstances in constructing a complex system which attempts to be fair, but the resulting scheme is incredibly complex and uncertain, as indicated by the fact that its features were still being revised and new problems discovered even within the last few days. According to staff, Texaco itself argued in negotiations that it foresaw the possibility of large numbers of disputes and that the resolution of them "might take 100 years." As the Deputy Director of the Bureau of Economics argues, for the FTC to recreate the Petroleum Entitlements Program when the agency has consistently challenged the regulatory actions of other agencies is inappropriate.[1] Moreover, the majority's confident reliance on only a five year requirement is speculative and may well prove inadequate.[2]

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[1] It is frequent Commission practice for an individual Commissioner to state publicly the theories and findings of staff in explaining his or her decision on a Commission decision if no confidential commercial information is disclosed. Nevertheless, the General Counsel recently prepared a memorandum interpreting our confidentiality rules as forbidding any individual Commissioner from stating publicly any staff arguments or conclusions prepared to aid Commission deliberations unless a majority of the Commission agrees. Needless to say, this sweeping interpretation would mean that the majority could pick and choose which staff findings an individual Commissioner could disclose. Thus, it provides ample opportunity for suppression of dissenting views as well as making the

(footnote cont'd)

The second problem is that the order does not include the safeguards that were built into the provisionally accepted *Socal/Gulf* order, in particular, holding the two companies separate until the proposed divestitures are approved and providing for additional assets, including crude oil, to be divested in order to insure spun off assets remain viable. The staff makes an argument that the concerns that necessitated the safeguards in *Socal/Gulf* are not applicable here. I disagree. The general proposition that was recognized in *Socal/Gulf* was that divestiture of oil company assets, particularly refineries, may not result in viable entities. One way to ensure these divestitures are successful is to include additional assets, such as a crude oil supply, in the divestiture package, and to hold the merging companies separate—and in effect retain the option to challenge the underlying transaction—if the divestitures prove to be unworkable.

The Commission justifiably claimed that the *Socal/Gulf* agreement was a major improvement over prior partial divestiture orders. But now, without any real ground for treating this agreement differently, it refuses to adopt the *Socal/Gulf* approach. The risk of unsuccessful divestitures arose most clearly in the case of the two refineries—Eagle Point and El Dorado. In the case of the El Dorado refinery, the Commission purports to have solved the problem of preserving it by allowing Texaco to retain it, along with pipeline and other assets, and instead divest its interest in the Wyco pipeline. Originally, staff says, the inclusion of the El Dorado refinery in the divestiture package with the Chase pipeline was justified on the grounds that this pipeline divestiture would not be viable without a refinery. It is not entirely clear why now the Wyco pipeline interest can be divested alone, but no additional assets are needed to insure viability. As for Eagle Point, the Commission hopes for the best.

Given that the Commission has not included any special safeguards in this order, it is enlightening to review the administration's response to Congressional consideration of H.R. 5452, introduced by Congressman Florio, which would insure that an oil company merger did not become final until the divestitures were approved.[3] The Justice Department opposed this bill, arguing: "its basic goals . . . are fully protected by existing procedures. . . . If a hold separate order is required pending any given divestiture, it can be obtained through

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process of Commissioners communicating with the public about what the agency is doing and thinking extremely cumbersome. The General Counsel's opinion has fortunately never been adopted by the Commission. It is impractical, contrary to past practice and highly inadvisable. I decline to follow it.

[2] *See, e.g.*, the Comments of California Attorney General John K. Van de Kamp (Comment No. 283) and independent refiner comments (No. 228, 236, 237, 240, 263).

[3] Similar legislation was introduced in the Senate by Senator Kassebaum.

consent or litigation."[4] Thus, we have the spectacle of the FTC failing to include safeguards in one merger order that it said were necessary in a similar case weeks ago, while the Justice Department opposes additional legislation on the grounds that the antitrust agencies can obtain these safeguards through existing procedures.

Conclusion

The error of the majority in this case has been to accept too readily the presumption that, whatever we do, the basic transaction must be preserved. As a result, we have accepted an extremely complex and uncertain partial divestiture plan along with a temporary and highly regulatory crude oil entitlements program. I continue to believe the Commission would have been more faithful to the Congressional intent behind Section 7 of the Clayton Act by seeking to enjoin this merger.

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[4] Letter from Robert A. McConnell, Assistant Attorney General for Legislative Affairs, to Congressman James J. Florio, June 13, 1984, p.6.

IN THE MATTER OF

GENSTAR LIMITED

MODIFYING ORDER IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 7 OF THE CLAYTON ACT

Docket No. C-3049. Consent Order, Nov. 10, 1980—Modifying Order, July 12, 1984

This order reopens the proceeding and modifies the Commission's Order issued on Nov. 10, 1980 (96 F.T.C. 795) to permit respondent to both ship cement from its Tilbury Island Plant in British Columbia to California, Oregon, Washington and Nevada, and acquire cement distribution terminals in those four states without prior Commission approval.

ORDER MODIFYING DECISION AND ORDER

Genstar Limited has requested that the Commission modify its Order in Docket No. C-3049 (1) to relieve Genstar of its obligation under Paragraph II of the Order to obtain, until January 31, 1990, Commission approval to ship cement it produces outside the United States to cement facilities it owns in the four-state area of Washington, Oregon, Nevada, and California ("four-state area"), and (2) to relieve Genstar of its obligation under Paragraph VII(B) to obtain, until January 31, 1985, Commission approval before acquiring active cement terminals in the four-state area. After duly considering Genstar's petition, the Commission has determined that Genstar has demonstrated changed circumstances of fact that warrant reopening of the Order, and that the Order should be modified in the manner that Genstar requests.

Before 1980, when Genstar acquired the Flintkote Company, Genstar had no cement plants in the relevant market and did not sell directly to end-users; Genstar, however, supplied cement to cement producers in the market. Genstar's proposed acquisition of Flintkote, the third largest competitor in the area, presented several alleged anticompetitive possibilities.

The Commission and Genstar agreed to a cease and desist Order against Genstar that allowed the proposed acquisition to take place, but that contained provisions designed to eliminate the possible anticompetitive effects of the acquisition. Paragraphs II and III, in conjunction with the cement terminal moratorium provision contained in Paragraph VII(B), were designed to avoid the possibility that Genstar would dominate the market through the combination of its status as a major supplier and its ownership of Flintkote. Paragraph II restricts Genstar's ability to import cement into the relevant area for its own use, and Paragraph III requires Genstar until December 31, 1984, to make available to producers in the market excess cement produced by the Canadian plant from which Genstar supplies cement to the relevant area. The provision in Paragraph VII(B) that restricts Genstar's ability to acquire active cement terminals in the relevant market was an adjunct to Paragraphs II and III.

When the Commission accepted the consent Order, it recognized that the Order's import restrictions would limit Genstar's ability to compete to its fullest in the relevant market; however, the provisions were believed to be necessary during the period of short supply that then prevailed, to eliminate the opportunity for Genstar to effect an anticompetitive supply squeeze. Due to increased capacity in the relevant market, such an event no longer is a realistic possibility. Consequently, there no longer is any reason to restrict Genstar from competing fully in the market. This changed circumstance of fact and the public interest therefore require modification of the Order. Accordingly,

It is ordered, That the proceeding be, and it hereby is, reopened.

It is ordered, That the Order be, and it hereby is, modified by (1) deleting Paragraph II of the Order, and (2) substituting for Paragraph VII(B) of the Order the following:

VII.

It is further ordered, That prior to January 31, 1985 Genstar shall cease and desist from acquiring, directly or indirectly, without the prior approval of the Federal Trade Commission, the whole or any part of:

* * * * * * *

B. any Product manufacturing plant located in any Cement Market Area.

Commissioner Calvani dissented.

IN THE MATTER OF

BROWN SHOE COMPANY, INC.

SET ASIDE ORDER IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT

Docket 7606. Modified Order, August 3, 1966—Order to Set Aside, July 16, 1984

This order grants petition of Brown Group, Inc. (formerly Brown Shoe Company, Inc. and hereafter "Brown") to reopen the proceeding in Docket No. 7606 and set aside the 1966 order entered against Brown which prohibited the company from entering into agreements that would prevent retailers from deciding to purchase a competitor's line of shoes or the amount of competitor's shoes to stock. Upon considering Brown's petition, the public comments and other relevant information, the Commission found that granting respondent's request would be in the public interest. The Commission noted that given the present characteristics of the shoe industry and Brown's lack of market power to exclude competitors, the 1966 order now serves no procompetitive purpose and may impede respondent's efforts to achieve efficient distribution of its products through law practices available to its competitors. Accordingly, the proceeding in Docket No. 7606 is reopened and the Commission's order of August 3, 1966, 70 F.T.C. 491, is set aside.

ORDER REOPENING AND SETTING ASIDE ORDER ISSUED AUGUST 3, 1966

By a petition filed on March 19, 1984, respondent Brown Group, Inc. (formerly Brown Shoe Company, Inc. and hereafter "Brown") requests that the Commission reopen the proceeding in Docket No. 7606 and set aside the order against Brown. Upon consideration of Brown's petition, the public comments, and other relevant information, the Commission now finds that the public interest warrants reopening the proceeding and setting aside the order.

The record describes an industry in which any attempt by Brown to impose exclusive dealing on retailers today would have no significant anticompetitive effects. Imports have dramatically penetrated the market, representing about 60 percent of present domestic consumption. Some 300 manufacturers account for U.S. production, with 25 providing about half of domestic output. There is no evidence that within this fragmented market structure any single competitor, whether a domestic manufacturer or supplier of imports, has significant market power to exclude other competitors. To the contrary, significant entry continues to occur, demonstrating a lack of natural or artificial barriers to entry.

Given the present characteristics of the shoe industry and that Brown does not have market power by which it may exclude competitors, the order now serves no procompetitive purpose and may impede

Brown's efforts to achieve efficient distribution of its products through lawful practices available to its competitors.

Accordingly,

It is ordered, That this matter be, and it hereby is reopened, and that the Commission's August 3, 1966 order be and it is hereby set aside.

IN THE MATTER OF

CALIFORNIA-TEXAS OIL COMPANY, ET AL.

CONSENT ORDER IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket C-3138. Complaint, July 16, 1984—Decision, July 16, 1984

This consent order requires a Glendale, Ca. company and its corporate president to cease making mileage or emission improvement claims for the "AWECO Mileage Extender" or any gasoline additive or automotive device, unless the claims can be substantiated by competent and reliable scientific tests. Respondents must also prominently disclose any material limitations or inferences that can be drawn from test results used to substantiate mileage or emission reduction claims. The order further bars the company from making any fuel economy or automotive emission performance claims using the phrase "up to" or words of similar import, unless a substantial number of consumers, under normal driving conditions, can achieve the maximum level of performance claimed.

Appearances

For the Commission: *Paul R. Roark,* Los Angeles, Ca.

For the respondent: *Pro se.*

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that California-Texas Oil Company, a California corporation, and Eileen M. Robertson, individually and as an officer and director of said corporation, hereinafter sometimes referred to as respondents, have violated the provisions of said Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

PARAGRAPH 1. Respondent California-Texas Oil Company ("CTO of California") is a corporation organized, existing and doing business under and by virtue of the laws of the State of California with its office and principal place of business located at 605 N. Louise Street, Glendale, California.

Respondent Eileen M. Robertson is president, a director and part owner of CTO of California. She formulates, directs and controls the acts and practices of said corporate respondent, including the acts and practices hereinafter set forth. Her address is the same as that of CTO of California.

PAR. 2. Respondents are now and for some time past have been engaged in manufacturing, offering for sale, sale, and distribution of a product known as AWECO Mileage Extender (hereinafter "AWECO"). Respondents, in connection with their offering AWECO for sale, have also published and disseminated, and now publish and disseminate, advertisements and other sales promotional materials for the purpose of promoting the sale of AWECO. AWECO is an automobile gasoline additive advertised to be a means of substantially improving fuel economy in automobiles and of reducing automobile emissions.

PAR. 3. In the course and conduct of their said business, respondents have disseminated and caused the dissemination of certain advertisements of AWECO by various means in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, including, but not limited to, television broadcasts of interstate transmission and the insertion of advertisements in newspapers with interstate circulations, for the purpose of inducing and which are likely to induce, directly or indirectly, the purchase of AWECO in or affecting commerce.

PAR. 4. Among the advertisements and other sales promotional materials disseminated by respondents are the advertisements identified as Exhibit A, which is attached hereto.

PAR. 5. Through the use of the advertisements referred to in Paragraph Four and other advertisements and sales promotional materials, respondents represented and now represent, directly or by implication, that:

a. Use of AWECO in an automobile is proven to increase mileage by an average of 15%.

b. Use of AWECO is an automobile is proven to increase mileage by 15%, or close to 15%.

c. Use of AWECO in an automobile is proven to increase mileage by up to 15%.

d. Use of AWECO in an automobile is proven to substantially improve fuel economy.

e. Competent and reliable tests prove the fuel economy claims made for AWECO.

PAR. 6. By and through the use of these and other representations, respondents have represented, directly or by implication, that:

a. Use of AWECO in an automobile will increase mileage by an average of 15% under circumstances normally and expectably encountered by consumers.

b. Use of AWECO in an automobile will increase mileage by 15% or close to 15% under circumstances normally and expectably encountered by consumers.

c. Use of AWECO in an automobile will increase mileage by up to 15% under circumstances normally and expectably encountered by consumers.

d. Use of AWECO in an automobile will substantially improve fuel economy under circumstances normally and expectably encountered by consumers.

e. Competent and reliable tests prove the fuel economy claims made for AWECO.

PAR. 7. In truth and in fact, contrary to respondents' representations in Paragraph Five:

a. Few, if any, consumers under circumstances normally and expectably encountered will, when using AWECO as directed in an automobile, extend mileage by an average of 15%, by 15%, or by up to 15%.

b. Few, if any, consumers under circumstances normally and expectably encountered will, when using AWECO as directed in an automobile, substantially improve fuel economy.

c. No competent and reliable tests prove the fuel economy claims made for AWECO.

Therefore, said advertisements and other sales promotional materials disseminated by respondents are false or deceptive.

PAR. 8. At the time respondents made the representations alleged in Paragraph Five of the complaint, they did not possess and rely upon a reasonable basis for such representations because, *inter alia:*

a. Respondents' tests were not designed or conducted to assess product performance in a manner appropriate and relevant to the representations made. For example:

1. Road tests were conducted under conditions different from those recommended in the instructions to consumers,

2. Both the drivers in the road tests and those conducting the tests knew when the additive was being added to the vehicles and were encouraged to perform in such way as to assure favorable results for the additive,

3. Cars showing favorable results were tested repeatedly to skew the test results, and

4. Alternator tests were conducted using two different engines in such a way as to make it impossible to know whether the differences in test results were attributable to the presence of the additive or to differences in the engines.

b. Even if respondents' test design and conduct were appropriate, they did not accurately rely upon the test results in making their performance representations. For example, despite the fact that the road tests showed an average miles per gallon increase in fuel economy of 9%, many of respondents' advertisements contained claims that AWECO would extend mileage by 15%.

c. Respondents' performance representations ignored unfavorable test data. For example:

1. Respondents systematically excluded cars from their road tests that showed no or little mileage improvement from the use of AWECO,

2. Respondents ignored chassis dynamometer tests that showed only a 1.6% increase in urban fuel economy driving and 2.22% increase in highway fuel economy, and

3. Respondents ignored road tests conducted by an independent laboratory that showed only a .99% increase in fuel economy.

Therefore, said advertisements and other sales promotional materials are deceptive and unfair.

PAR. 9. Exhibit A and other advertisements and sales promotional materials disseminated by respondents represent, directly or by implication, that respondents had a reasonable basis for making, at the time they were made, the representations alleged in Paragraph Five. In truth and in fact, respondents had no reasonable basis for such representations. Therefore, said advertisements and other sales promotional materials disseminated by respondents are deceptive and unfair.

PAR. 10. In the course and conduct of their business, and at the times mentioned herein, respondents have been, and now are, in substantial competition in or affecting commerce with corporations, firms and individuals engaged in the sale of products for improving automobile mileage and reducing automobile emissions.

PAR. 11. The use by respondents of the aforesaid false or deceptive representations, and the dissemination of the aforesaid false or deceptive advertisements and other sales promotional materials have had and now have the capacity and tendency to mislead members of the consuming public into the erroneous and mistaken belief that said representations were and are true and into the purchase of substantial quantities of products sold by respondents by reason of said erroneous and mistaken belief.

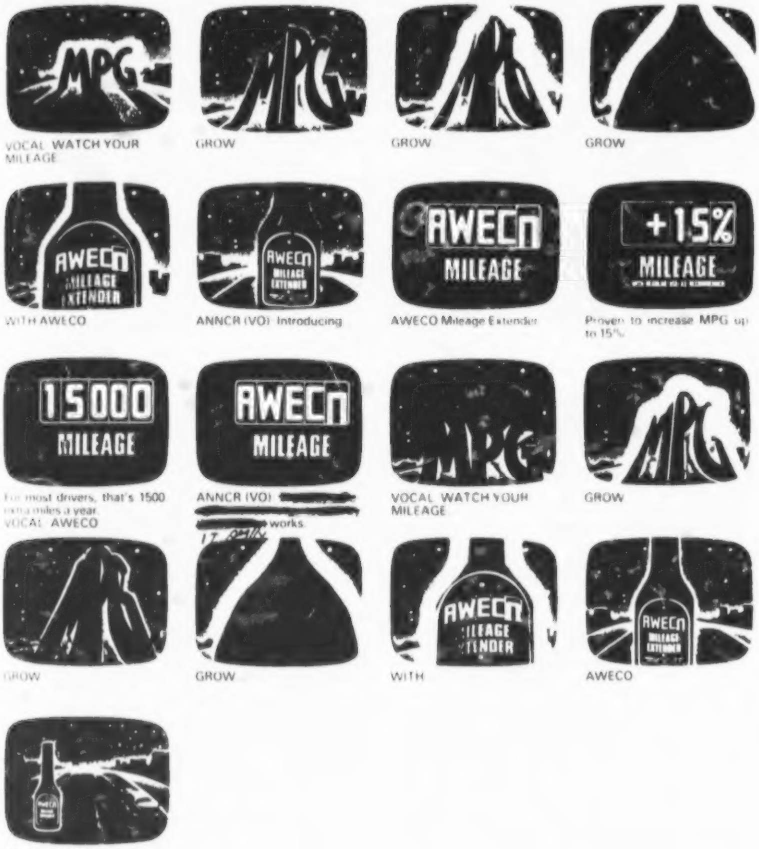
PAR. 12. The acts and practices of respondents, as herein alleged, were and are all to the prejudice and injury of the public and of respondents' competitors and constituted, and now constitute, unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce in violation of Section 5 of the Federal Trade Commission Act. The acts and practices of respondents, as herein alleged, are continuing and will continue in the absence of the relief herein requested.

EXHIBIT A

AWECO

TITLE "GROW"
JOB NO. TBD

LENGTH 30 SECONDS
DATE 5 10 80


MPG
MPG
AWECO
MILEAGE
EXTENDER
AWECO
MILEAGE
EXTENDER
AWECO
MILEAGE
+15%
MILEAGE
15000
MILEAGE
AWECO
MILEAGE
MPG
MPG
AWECO
MILEAGE
EXTENDER
AWECO
MILEAGE
EXTENDER

VOCAL: WATCH YOUR MILEAGE

GROW

GROW

GROW

WITH AWECO

ANNCR (VO): Introducing

AWECO Mileage Extender.

Proven to increase MPG up to 15%.

For most drivers, that's 1500 extra miles a year.
VOCAL: AWECO

ANNCR (VO): [redacted] works.

VOCAL: WATCH YOUR MILEAGE

GROW

GROW

GROW

WITH

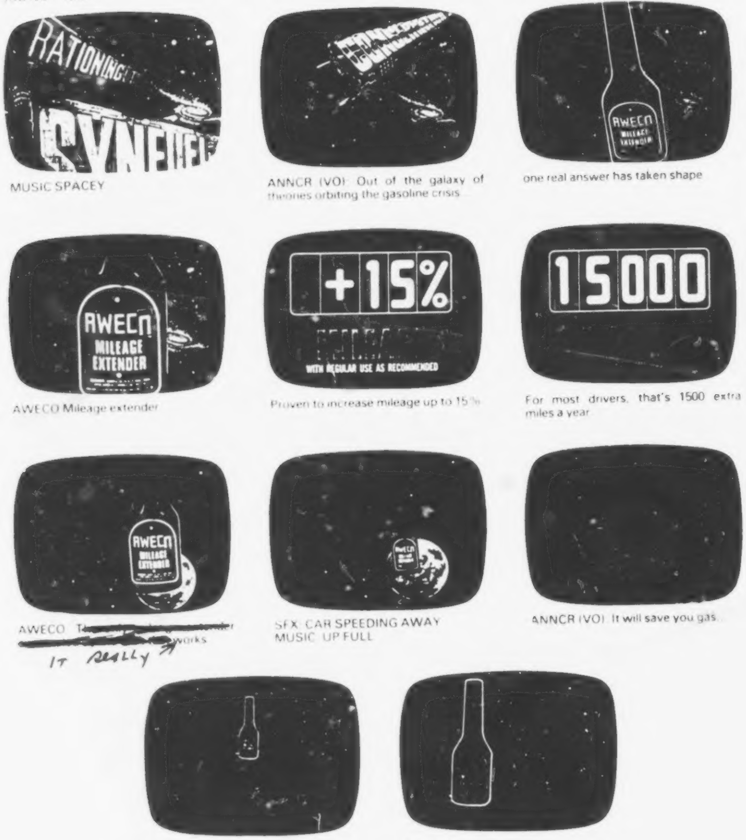
AWECO

MUSIC: BUTTON

AWECO

TITLE GALAXY
JOB NO TBD

LENGTH 30 SECONDS
DATE 5/10/80


RATIONING
SYNFUEL
AWECO MILEAGE EXTENDER
+15%
WITH REGULAR USE AS RECOMMENDED
15000

MUSIC SPACEY

ANNCR (VO): Out of the galaxy of theories orbiting the gasoline crisis...

one real answer has taken shape

AWECO Mileage extender

Proven to increase mileage up to 15%

For most drivers, that's 1500 extra miles a year

AWECO ~~T[illegible]~~ works

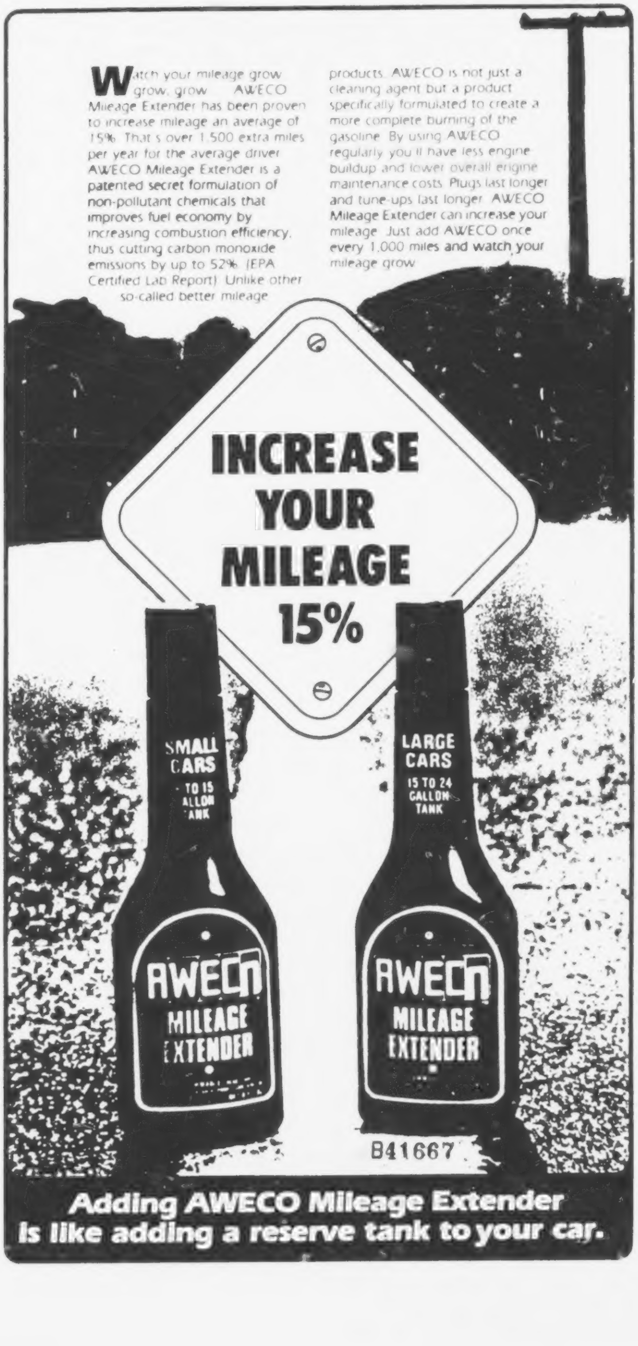
IT REALLY

SFX: CAR SPEEDING AWAY
MUSIC UP FULL

ANNCR (VO): It will save you gas...

and it will do it now

AWECO



Watch your mileage grow grow, grow AWECO Mileage Extender has been proven to increase mileage an average of 15%. That's over 1,500 extra miles per year for the average driver. AWECO Mileage Extender is a patented secret formulation of non-pollutant chemicals that improves fuel economy by increasing combustion efficiency, thus cutting carbon monoxide emissions by up to 52% (EPA Certified Lab Report). Unlike other so-called better mileage products, AWECO is not just a cleaning agent but a product specifically formulated to create a more complete burning of the gasoline. By using AWECO regularly you'll have less engine buildup and lower overall engine maintenance costs. Plugs last longer and tune-ups last longer. AWECO Mileage Extender can increase your mileage. Just add AWECO once every 1,000 miles and watch your mileage grow.

INCREASE YOUR MILEAGE 15%
SMALL CARS
TO 15 GALLON TANK
LARGE CARS
15 TO 24 GALLON TANK
AWECO
MILEAGE EXTENDER
AWECO
MILEAGE EXTENDER
B41667
Adding AWECO Mileage Extender is like adding a reserve tank to your car.

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondents named in the caption hereof, and the respondents having been furnished thereafter with a copy of a draft of complaint which the Los Angeles Regional Office proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondents with violation of the Federal Trade Commission Act; and

The respondents, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondents of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondents that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondents have violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent California-Texas Oil Company is a corporation organized, existing and doing business under and by virtue of the laws of the State of California, with its office and principal place of business located at 1173 North Westmoreland Avenue, in the City of Los Angeles, State of California.

Respondent Eileen M. Robertson is an officer of said corporation. She formulates, directs and controls the policies, acts and practices of said corporation, and her principal office and place of business is located at the above stated address.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondents, and the proceeding is in the public interest.

ORDER

I.

It is ordered, That respondent California-Texas Oil Company, a corporation, its successors and assigns, and its officers, and respondent Eileen M. Robertson, individually and as an officer and director of the corporate respondent, and respondents' agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, labeling, offering for sale, sale or distribution of the gas additive known as AWECO Mileage Extender ("AWECO"), any other fuel additive, any engine oil additive, or any automobile retrofit device, as "automobile retrofit device" is defined in Section 301 of the Energy Policy and Conservation Act of 1975, 15 U.S.C. 2011, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

a. Representing, directly or by implication, that any such additive or device will or may result in fuel economy improvement when installed in an automobile, truck, recreational vehicle or other motor vehicle unless:

1. Such representation is true;
2. At the time of making such representation, respondents possess and rely upon, as substantiation for the representation, written results of competent and reliable scientific testing that isolate the effects of the additive or device. Respondents may use such tests as the then current urban dynamometer driving schedule (40 C.F.R. 86, Appendix I) or the then current highway fuel economy driving schedule (40 C.F.R. 600, Appendix I) established by the Environmental Protection Agency or other tests of an equivalent competency and reliability; and
3. Respondents, when using the results of any test(s) required by this Part, clearly and prominently disclose with such representation any material limitation upon the test results or inferences that can be drawn from the results.

b. Representing, directly or by implication, that any such additive or device will or may result in a reduction in automotive emissions from the operation of an automobile, truck, recreational vehicle or other motor vehicle when installed in such vehicle unless:

1. Such representation is true;
2. At the time of making such representation, respondents possess and rely upon written results of competent and reliable scientific

testing, as substantiation for the representation, done by a laboratory using tests such as, or equivalent in competency and reliability to, a chassis dynamometer test performed according to the 1975 Federal Test Procedure; and

3. Respondents, when using the results of any test(s) required by this Part, clearly and prominently disclose with such representation any material limitation upon the test results or inferences that can be drawn from the results.

c. Making any fuel economy or automotive emissions performance claim which uses the phrase "up to" or words of similar import, unless the maximum level of performance claimed can be achieved by an appreciable number of consumers under circumstances normally and expectable encountered by consumers.

d. Representing, directly or by implication, that any performance claim about any such additive or device is based upon any competent and reliable test(s) or survey(s), unless such representation is true.

e. Misrepresenting, in any manner, the purpose, content, or conclusion of any test or survey pertaining to any such additive or device.

For the purposes of Part I, a competent and reliable test means one in which persons qualified to do so conduct the test and evaluate its results in an objective manner using procedures that ensure accurate and reliable results.

II.

It is further ordered, That respondents, in connection with the advertising, labeling, offering for sale, sale or distribution of any product or service in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from failing to maintain accurately the following records, which shall be available for inspection by Commission staff upon request: copies of and dissemination schedules for all advertisements and labels, other sales promotional materials, and post-purchase materials disseminated by respondents directly or through any business entity; copies of all documents generated by the requirements of Parts III and IV of this order. Such documentation shall be retained by respondents for a period of three (3) years from the last date any such advertising or material is disseminated, except that documentation relating to Parts III and IV of the order shall be retained by respondents for a period of three (3) years from the last date a copy of this order is disseminated.

III.

It is further ordered, That respondents do forthwith distribute a copy of this order to all operating divisions of the corporate respondent, and to all present or future personnel, agents or representatives of respondents having sales, advertising, or policy responsibilities with respect to the subject matter of this order, and that respondents secure from each such person a signed statement acknowledging receipt of said order.

IV.

It is further ordered, That respondents notify the Commission at least thirty (30) days prior to any proposed change in the corporate respondent such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change in the corporation that may affect compliance obligations arising out of the order.

V.

It is further ordered, That the individual respondent named herein promptly notify the Commission of the discontinuance of her present business or employment. In addition, for a period of 5 years from the date of service of this order, the individual respondent shall promptly notify the Commission of each affiliation with a new business or employment. Each such notice shall include the individual respondent's new business address and a statement of the nature of the business employment in which the respondent is newly engaged as well as a description of the individual respondent's duties and responsibilities in connection with the business or employment. The expiration of the notice provision of this paragraph shall not affect any other obligation arising under this order.

VI.

It is further ordered, That respondents shall within sixty (60) days after service upon them of this order, file with the Commission a report, in writing, setting forth in detail the manner and form in which they have complied with this order.

IN THE MATTER OF

INTERNATIONAL TELEPHONE & TELEGRAPH CORPORATION, ET AL.

FINAL ORDER, OPINION, ETC. IN REGARD TO VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 2(a) OF THE CLAYTON ACT, AS AMENDED

Docket 9000. Complaint November 26, 1974—Final Order July 25, 1984

For reasons set forth in the Commission's Opinion, this final order reverses the ALJ's initial decision, denies complaint counsel's appeal, grants appeal of respondents and dismisses the complaint charging a New York City conglomerate and its wholly-owned baking company subsidiary with alleged violations of federal law. The complaint had alleged that the baking company had attempted to monopolize the white bread product sales market in five geographic areas and caused competitive injury in those markets by, among other things, engaging in predatory or discriminatory pricing practices for significant periods of time.

Appearances

For the Commission: *Jerry A. Philpott, Renee S. Henning, Stephen E. Nagin, Richard Malatt, Gilda E. Rodriguez, Marimichael O. Skubel* and *Allen M. Hickey*

For the respondents: *John H. Schafer, S. William Livington, Jr., David J. Cynamon, Bruce D. Sokler* and *Jane H. Chalmers, Covington & Burling,* Washington, D.C. and *Craig D. Walley* and *Gordon Thomas,* New York City.

COMPLAINT

The Federal Trade Commission, having reason to believe that the above-named respondents have violated and are now violating Section 5 of the Federal Trade Commission Act, as amended (15 U.S.C. 45), and subsection (a) of Section 2 of the Clayton Act, as amended by the Robinson-Patman Act (15 U.S.C. 13), and believing that a proceeding by it in respect thereof is in the public interest, hereby issues this complaint charging as follows:

Definitions

1. For the purpose of this complaint, the following definitions shall apply:

(a) *Bread* shall refer to white pan bread and bread type rolls and related products but not to specialty breads.

(b) *Wholesale bakers* are bakers of bread which sell at wholesale to other establishments including groceries, restaurants, hotels and institutions. Bakeries owned and operated by grocery chains which distribute the bakeries' products through the chains' own retail grocery stores are not wholesale bakers. [2]

Respondents

2. Respondent International Telephone and Telegraph Corporation ("ITT") is a corporation organized and existing under the laws of the State of Delaware with its principal place of business located at 320 Park Avenue, New York, New York. ITT is a conglomerate engaged directly and/or through subsidiaries in numerous and diverse businesses including, among others: the development, manufacture, distribution, servicing and operation of electronic and telecommunication equipment and other industrial and consumer products; life, fire and casualty insurance; processing wood pulp; mining; business and consumer services; and the manufacture and distribution of food products and automotive parts. In 1973, ITT had sales of approximately $10.2 billion, making it the ninth largest domestic corporation in terms of sales, and assets of approximately $10.1 billion, making it the eighth largest in terms of assets.

3. Respondent ITT Continental Baking Company, Inc. ("ITT Continental"), is a corporation organized, existing and doing business under the laws of the State of Delaware, with its office and principal place of business located at Halstead Avenue, Rye, New York. ITT Continental is a wholly-owned subsidiary of ITT, which acquired it in 1968 from its predecessor, Continental Baking Company. ITT Continental is engaged in the manufacture, sale and distribution of bread, cakes, snacks such as potato chips, frozen prepared foods, candy and ingredients for the bakery industry. In 1972, ITT Continental's net sales were approximately $865 million. In 1972, ITT Continental would have been ranked as the 165th largest domestic corporation in terms of sales if it were not owned by ITT.

4. ITT controls, approves and benefits from the practices of ITT Continental.

Jurisdiction

5. In the course and conduct of their businesses, respondents are and for a substantial period of time have been engaged in selling bread throughout various States of the United States, and have caused bread baked in various states to be shipped to purchasers in various other states. Thus, respondents are and at all times relevant

herein have been engaged in a continuous and substantial course of trade in commerce, as "commerce" is defined in the Federal Trade Commission Act and the Clayton Act, as amended by the Robinson-Patman Act. [3]

COUNT I

Alleging violations of Section 5 of the Federal Trade Commission Act.

Trade and Commerce

6. The relevant product market for purposes of this complaint is the baking, sale and distribution of bread by wholesale bakers. The wholesale baking of bread is the largest and most significant submarket of the bread baking industry. Relevant geographic markets consist of regional and local markets in the United States where bread is sold by ITT Continental, and aggregates thereof.

7. The baking, sale and distribution of bread is a substantial industry in the United States. In 1972, approximately 15.6 billion pounds of bread including specialty breads were sold in the United States, with a retail value of approximately $3.3 billion. Of this, approximately 87.5% was baked and sold by wholesale bakers.

8. Concentration in the nation's bread industry is increasing. In 1963 the four largest bakers of bread and specialty breads accounted for 24% of the nation's bread sales; the eight largest accounted for 36%. By 1971 the four largest had increased their share to 30% and the eight largest to 40%. Concentration among the nation's wholesale bakers is higher. In 1963 the top four wholesale bakers of bread and specialty breads accounted for 31% of the total sales of the nation's wholesale bakers. By 1970 this had risen to over 37%. Between 1958 and 1972 the number of bakery plants declined by 45%. From January 1972 to mid-1973, 43 wholesale baking firms and 80 wholesale bakery plants closed.

9. Shares of total sales at the national level understate concentration in the bread industry. Due to its short shelf life and high transportation cost, most bread is sold within 150 miles of the bakery. Concentration is significantly higher in local and regional markets than in the nation as a whole, with 4-firm concentration ratios substantially exceeding 50% in many such markets.

10. Barriers to entry into wholesale bread baking are high. Significant start-up costs are associated with a new bakery, particularly with respect to establishing routes and obtaining sufficient shelf space. Because bread shelf space of grocers is limited, the introduction of a new brand means displacement of [4] established brands. Established multiplant wholesale bakers with interstate treasuries histori-

cally have met or bettered price concessions and promotions offered by bakers trying to expand or enter into their markets. Moreover, since bread is a homogenous product which is differentiated on the basis of sales and advertising expenditures, a new entrant who seeks to alter consumer preferences for established brands is placed at a substantial cost disadvantage.

11. ITT Continental is the world's largest bread baker. Its net sales of bread in 1973 were approximately $475 million. This represents a 47% increase over 1968, the year in which ITT acquired Continental Baking Company. In 1970 ITT Continental's net sales of bread were almost half again as large as the next largest wholesale baker, Campbell-Taggart Baking Company. ITT Continental bakes bread in 48 bakeries located in 30 states and the District of Columbia and distributes it through in excess of 300 depots to areas in 46 states occupied by 70% of the population of the United States. ITT Continental's share of the nation's bread industry has grown steadily.

12. ITT Continental's market shares in regional and local markets are substantially higher than its share of national sales. ITT Continental has over 75% of the wholesale baker market in 4 regional or local markets; over 60% in 8; over 50% in 17; over 40% in 37.

13. ITT Continental is also the nation's largest producer of snack cakes, which it markets under the "Hostess" label. In 1973, ITT Continental's snack cake sales were $315 million. In some areas snack cakes and bread are distributed by the same ITT Continental routes.

14. ITT Continental is one of few multistate wholesale bakers. In competition with other multistate wholesale bakers such as Campbell-Taggert Baking Company, American Bakeries Company, and Interstate Brands Corporation, as well as those local wholesale bakers who are still in existence, ITT Continental sells and distributes bread in most of the populous portions of the United States. [5]

15. ITT Continental's wholesale baking business was built and conducted and is now conducted on a national basis. From its headquarters in Rye, New York, ITT Continental centrally purchases raw materials for the production of bread, as well as supplies, equipment, and other needs. Advertising, both national and local, is prepared and placed in media by ITT Continental's headquarters. ITT Continental at all times maintains control, directly from its headquarters or through various regional offices, over the activities of its bakeries, such control being exercised with respect to, among other matters, planning and sales objectives, national accounts, the area in which and the price at which each bakery is permitted to sell, standards of products maintained by said bakeries, all but minor repairs to plants and equipment, personnel policies, and funds collected and disbursed by said bakeries.

Acts, Practices and Methods of Competition

16. ITT Continental and ITT jointly set for ITT Continental its sales and profit budgets and policies, including sales growth goals, which force ITT Continental managers to behave in a predatory manner. Through a requirement for detailed and systematic reports from ITT Continental with respect to all of its significant business decisions, ITT agrees upon, and/or concurs and acquiesces in most of the acts, practices and methods of competition engaged in by ITT Continental, including most or all of those hereinafter set forth.

17. Respondents plan to achieve dominance in wholesale baking in all relevant geographic markets, seeking to attain their objective by engaging in the acts, practices and methods of competition hereinafter set forth, most of which have been and are directed to specific geographic markets.

18. With the intent to lessen, hinder or restrain competition and/or to attain monopolies in wholesale baking in one or more relevant geographic markets, beginning at least as early as 1952, and continuing thereafter up to and including the date of this complaint, respondents and the predecessor of ITT Continental, Continental Baking Company, have engaged in various acts, practices and methods of competition including, but not limited to, the following: **[6]**

(a) Acquisitions of a number of wholesale bakers;

(b) Since 1962, acquisitions of at least three independent bakers in violation of a Federal Trade Commission order forbidding such acquisitions;

(c) Sales of bread below their cost or at predatory prices for substantial periods of time in various geographic markets;

(d) Subsidization of sales below cost or at predatory prices in various geographic markets by sales at higher prices in less competitive geographic markets;

(e) Discriminations in price, directly or indirectly, between purchasers of bread of like grade and quality;

(f) Paying for services or facilities furnished by selected customers and/or furnishing services to selected customers to induce such customers to maintain and/or increase purchases of respondents' bread;

(g) Furnishing allowances, discounts and other things of value to customers or customers' employees for shelf and/or other merchandising space in grocery stores;

(h) Systematic concentration of advertising and consumer and trade promotions in connection with the sale of bread at predatory prices in various geographic markets; and

(i) Use of its dominant position in the sale of snack cakes and profits resulting therefrom to increase bread sales and to subsidize losses thereon. [7]

Effects

19. The effects of the acts, practices and methods of competition described in Paragraphs 16, 17 and 18 are, among others, to:

(a) Impair the ability of wholesale bakers to compete with ITT Continental;

(b) Induce small wholesale bakers to discontinue the production and sale of bread;

(c) Aggravate the trend towards concentration in wholesale baking;

(d) Deter new entrants and raise barriers to entry into the wholesale baking industry;

(e) Deter existing wholesale bakers from undertaking competitive initiatives;

(f) Inhibit growth of existing wholesale bakers;

(g) Substantially hinder, lessen, eliminate, injure, destroy and/or foreclose actual and potential competition in wholesale baking; and

(h) Increase the probability that respondents will attain a monopoly in the wholesale baking industry in each and all relevant geographic markets. [8]

Violations

20. The acts, practices and methods of competition alleged in this complaint constitute attempts by respondents to monopolize and injure competition in the wholesale baking industry in relevant geographic markets in violation of Section 5 of the Federal Trade Commission Act.

21. The acts, practices and methods of competition alleged in this complaint constitute unfair methods of competition or unfair acts or practices by respondents in violation of Section 5 of the Federal Trade Commission Act.

COUNT II

Alleging violations of subsection (a) of Section 2 of the Clayton Act, as amended by the Robinson-Patman Act.

22. Each of the allegations in Paragraphs 1 through 5 herein are incorporated in this Count II as though set forth in full.

23. In the course and conduct of their business in commerce, ITT and ITT Continental, now, and for many years past have been in substantial competition with other corporations, partnerships, individuals and firms engaged in the manufacture, distribution and sale of bread.

24. Respondents, in the course and conduct of their business in commerce, as above described, have for a number of years discriminated and now are discriminating in price, directly or indirectly, between different purchasers of bread, by selling bread of like grade and quality to some of such purchasers at substantially higher prices than to other of such purchasers.

Among the methods by which respondents discriminate between said purchasers is the granting of discounts of 5 to 12% and more off the list or regular prices to some customers in a trading area and denying such discounts to competing customers in the same trading area, and to customers in other trading areas. [9]

25. The effect of such discriminations in price as alleged herein may be substantially to lessen competition or tend to create a monopoly in the lines of commerce in which respondents and respondents' customers are respectively engaged; or to injure, destroy or prevent competition with respondents or with purchasers therefrom who receive the benefit of such discriminations.

26. The aforesaid acts and practices of the respondents constitute violations of subsection (a) of Section 2 of the Clayton Act, as amended by the Robinson-Patman Act.

INITIAL DECISION BY

MILES J. BROWN, ADMINISTRATIVE LAW JUDGE

MAY 1, 1981

INTRODUCTION

The Federal Trade Commission issued its complaint in this matter on November 26, 1974 (mailed December 16, 1974), charging respondents, International Telephone & Telegraph Corporation ("ITT") and ITT Continental Baking Company, Inc. ("Continental") with unfair methods of competition or unfair acts or practices in violation of Section 5 of the Federal Trade Commission Act (15 U.S.C. 45) and with discriminations in price in violation of Section 2(a) of the Clayton Act, as amended by the Robinson-Patman Act (15 U.S.C. 13(a)). [2]

Initial Pleadings

More particularly, the Commission charged that Continental, until its acquisition by ITT in 1968, and Continental and ITT since that time, have engaged in certain practices with the intent to lessen, hinder or restrain competition or to attain monopolies in wholesale baking in one or more relevant geographic markets. The Commission alleged that the practices challenged included, but were not limited to, the following (*See* Complaint ¶ 18):

(a) Acquisitions of a number of wholesale bakers;

(b) Since 1962, acquisitions of at least three independent bakers in violation of a Federal Trade Commission order forbidding such acquisitions;

(c) Sales of bread below their cost or at predatory prices for substantial periods of time in various geographic markets;

(d) Subsidization of sales below cost or at predatory prices in various geographic markets by sales at higher prices in less competitive geographic markets;

(e) Discriminations in price, directly or indirectly, between purchasers of bread of like grade and quality;

(f) Paying for services or facilities furnished by selected customers or furnishing services to selected customers to induce such customers to maintain or increase purchases of respondents' bread;

(g) Furnishing allowances, discounts and other things of value to customers or customers' employees for shelf or other merchandising space in grocery stores;

(h) Systematic concentration of advertising and consumer and trade promotions in connection with the sale of bread at predatory prices in various geographic markets; and

(i) Use of its dominant position in the sale of snack cakes and profits resulting therefrom to increase bread sales and to subsidize losses thereon.

The Commission alleged that the effects of the challenged practices are to (Complaint ¶ 19):

(a) Impair the ability of wholesale bakers to compete with Continental;

(b) Induce small wholesale bakers to discontinue the production and sale of bread;

(c) Aggravate the trend towards concentration in wholesale baking;

(d) Deter new entrants and raise barriers to entry into the wholesale baking industry;

(e) Deter existing wholesale bakers from undertaking competitive initiatives; [3]

(f) Inhibit growth of existing wholesale bakers;

(g) Substantially hinder, lessen, eliminate, injure, destroy and/or foreclose actual and potential competition in wholesale baking; and

(h) Increase the probability that respondents will attain a monopoly in the wholesale baking industry in each and all relevant geographic markets.

The Commission also alleged that respondents have discriminated in price between different purchasers of bread by selling bread of like grade and quality to some of such purchasers at substantially higher prices than to other of such purchasers, the effect of which may be substantially to lessen competition or tend to create a monopoly in the lines of commerce in which respondents and respondents' customers are respectively engaged (Complaint ¶ 24).

In the notice of contemplated relief that accompanied the complaint, the Commission advised that, if the charges alleged in the complaint were sustained, it may, among other provisions, order respondents to divest wholesale baking assets, including bakery plants and other facilities in one or more areas, and require the licensing of brands or trademarks for respondents' bread under such terms as are consistent with the restriction of competition in the relevant markets (Complaint at 11).

In their answer (filed March 21, 1975) respondents admitted certain background facts, but denied all allegations as to any violation of Section 5 of the Federal Trade Commission Act or Section 2(a) of the Clayton Act, as amended. Respondents also put forth as defenses certain prior actions of the Commission inconsistent with the theory of the complaint in Docket 9000 and the fact that certain challenges to their practices should be barred because of undue passage of time. Respondents further asserted that respondent ITT was not responsible for Continental's actions before September 1968, and that after that date it, being a corporation separate and distinct from Continental, has not engaged in the manufacture, sale, or distribution of bread. As to the charges of price discrimination, respondents raised the "cost justification" and "meeting competition" defenses. Finally, respondents asserted that the Commission lacked authority, on the basis of the allegations of the complaint, to secure the relief set forth in the notice of contemplated relief.

Sanctions Order

In the course of extensive post complaint discovery, complaint counsel sought detailed information on which they could recompute cost figures for individual bread varieties, cost figures which they considered essential to sustain the "sales below cost" allegations of the complaint. Respondents, stating that such an investigation was, in their opinion, beyond the scope of the Commission's complaint, on December 10, 1976, [4] refused to produce any further documents to support complaint counsel's efforts to develop a different cost accounting system from that which was employed by Continental during the years covered by the complaint.

Following complaint counsel's application for sanctions available under Section 3.38 of the Commission's Rules of Practice, and the

Administrative Law Judge's order of February 16, 1977, granting the application for sanctions, an order was issued March 22, 1977, imposing sanctions on respondents for failure to produce all documents deemed essential to recompute Continental's costs. The "sanctions order" provided that, for specific geographic markets during specific time periods, complaint counsel were deemed to have established that Continental sold bread below cost no matter how cost is measured. The sanctions order also provided that Continental could not introduce into evidence or otherwise rely upon the documents which it failed to produce and that it could not object to complaint counsel's use of other relevant material and reliable evidence to demonstrate that Continental made sales below cost in the designated geographic markets for the time periods specified.

Respondents were granted leave to file a limited appeal to the Commission on the policy question of whether it would be more appropriate for the Commission to seek district court enforcement of the subpoena as it related to the "withheld cost documents" rather than impose the sanctions for withholding the documents. On June 29, 1977, the Commission issued its order denying respondents' application for review.

Following the Commission's denial of the application for review, respondents made a continuous effort to require complaint counsel to accept their tender of the withheld documents and to obtain an order vacating the sanctions order. Complaint counsel steadfastly refused to accept those documents and respondents' motions were denied. (*See* orders dated November 7, 1977; September 28, 1979, April 15, 1980).

Respondents' Discovery

As complaint counsel's pretrial discovery neared completion at the end of 1977, it was agreed that respondents' discovery directed to Continental's wholesale baker competitors would be held in abeyance until the conclusion of the case-in-chief. Although broad subpoenas were issued to these nonparties in order to ensure preservation of documents, return dates thereon were suspended. After the case-in-chief was concluded, limited returns were negotiated with four of Continental's wholesale baker competitors.

Hearings

Adjudicative hearings commenced June 19, 1978 and 81 days of trial were held intermittently until October 15, 1980. [5] Complaint counsel's case-in-chief used 53 trial days, respondents' answering case used 16 trial days, complaint counsel's rebuttal case used 11-1/2 days and respondents surrebuttal case used 1/2 day. Ten of these hearing dates were devoted entirely to the handling of documentary material.

After the close of complaint counsel's case-in-chief on June 7, 1978, respondents filed numerous motions to dismiss the complaint in certain particulars, all of which were denied (Order Denying Respondents' Motion to Dismiss the Complaint as to International Telephone and Telegraph Company ("ITT"), dated September 21, 1979; Order Denying Respondents' Motion to Dismiss the Seattle phase of the Case, dated September 24, 1979; Order Denying Respondents' Motion to Dismiss the Complaint as to the Price Discrimination Allegations (Count II), dated October 5, 1979)). Earlier motions to dismiss the Denver and Minneapolis phases of the case on the grounds that the evidence would be stale were also denied (9182; order dated January 15, 1979).

Time to File Initial Decision

On October 17, 1980, the Administrative Law Judge closed the record for the receipt of evidence, although the record was reopened on November 4, 1980, to permit the receipt into evidence of certain documents that complaint counsel acquired from respondents after October 17, 1980. On October 27, 1980, the Commission granted a joint motion of counsel for extensions of time in which to file proposed findings and reply briefs. The Commission also extended the time for filing the initial decision until February 27, 1981. On December 23, 1980, the Commission issued an order, on complaint counsel's motion, granting the parties a further extension of time in which to file proposed findings and reply briefs and extended the time for filing the initial decision until March 14, 1981. Proposed findings were filed on January 9, 1981, and reply briefs were filed on February 6, 1981. On March 4, 1981, the Commission granted the Administrative Law Judge's request for an extension of time until April 10, 1981, in which to file the initial decision, and on April 7, 1981, further extended that time to May 1, 1981.

Motions and Abbreviations

Any motions appearing on the record not heretofore specifically ruled upon either directly or by the necessary effect of the conclusions in this initial decision are hereby denied. The proposed findings and conclusions submitted by counsel supporting the complaint ("CCPF") and counsel for respondents ("RPF") have been given careful consideration and to the extent not adopted by this decision, in the form proposed or in substance, are rejected as not supported by the evidence, as argumentative, as immaterial or based on material not in evidence. Other abbreviations used in this initial decision are: CX - Commission Exhibit; RX - Respondents' Exhibit; CC Mem - Complaint counsel's memorandum of law in support of CCPF; RBr - [6] Respondents' brief in support of RPF; CC Reply Br. - Complaint counsel's reply brief. and R Reply Br. - Respondents' reply brief.

Collateral Proceedings

Most of the factual and legal issues presented in this case arise from the facts and circumstances relating to Continental's pricing practices in five general market areas; *i.e.*, Denver, Minneapolis-St. Paul, Los Angeles, Northern California and Cleveland-Akron. Continental's practices have been, and in some cases, continue to be, the subject of private litigation. In Denver, a District Court's determination that Continental had violated Section 2(a) of the Clayton Act, as amended, was upheld by the Court of Appeals, *Continental Baking Co.*v. *Old Homestead Bread Co.*, 476 F.2d 97 (10th Cir. 1973), *cert. denied*, 414 U.S. 975. In Minneapolis-St. Paul, private damage suits filed by Zinsmaster Baking Co., Pan O Gold Co., and Tender Krust/Creamy Crust, were settled before trial (CX 299F, 300A), *Zinsmaster Baking Co., et al.* v. *ITT Continental Baking Company*, No. 4-68 Civ. 96 (D. Minn). In Los Angeles, a suit brought by several of Continental's wholesale baker competitors was being prepared for trial during the final hearings in this matter. *See Wm. Inglis & Sons, Inc.* v. *ITT Continental Baking Co.*, (S.D. Cal. No. 78-3604). In Northern California a District Court's jury verdict for plaintiff was reversed by the district judge on a motion by Continental for judgment notwithstanding the verdict, *Wm. Inglis & Sons, Inc.* v. *ITT Continental Baking Co.*, 461 F.Supp. 410 (N.D. Cal. 1978), appeal pending in the Court of Appeals for the Ninth Circuit. In Cleveland, the representatives of the creditors of Laub Baking Co. have filed a treble damage suit against Continental, a matter that was being prepared for trial during the final hearings in this matter, *Melamed* v. *ITT Continental Baking Co.* No. 74-960 (N.D. Ohio). With respect to a sixth market, Seattle, complaint counsel have alleged that Continental engaged in certain anticompetitive practices, although no price discrimination conduct or sales below cost are alleged. Continental's practices in Seattle were also the subject of a private damage suit. The Court of Appeals applied the labor exemption of the antitrust laws and remanded it to the District Court for dismissal, *Granddad Bread Inc.* v. *Continental Baking Co.*, 612 F.2d 1105 (9th Cir. 1979), *cert. denied*, 49 USLW 3493 (January 12, 1981).

Although the record in this matter contains certain materials collected or used in evidence in these other cases, this case is a *de novo* consideration of all issues, factual and legal, raised by the allegations of the complaint in Docket 9000, as modified or explained during the administrative proceedings.

In addition, the Commission investigated Continental's practices in

Denver and Minneapolis, and closed both files [7] without prejudice to the right of the Commission to reopen those investigations. (*See* Attachment A to Respondent's Motion to Dismiss the Denver Phase of the Case; RX 402C). A compliance investigation in Seattle during the early 1970's, relating to a 1964 Commission order prohibiting price-fixing, was closed without action (*See* Order Denying Respondents' Motion to Dismiss the Seattle Phase of the Case, dated September 24, 1979.)

In Camera Treatment

In camera treatment has been afforded many of the documentary exhibits in this case (including some in the rejected file). Although it was generally understood that all *in camera* status would expire on the date of the initial decision in this matter the record contains some exceptions and ambiguities on this subject (3999, 9166, 11466, 11429–49, 11829–30, 11319).

During the adjudicative hearings, counsel for Interstate moved to have Rxs 1051C–D; 1145A–J; 1146A–M; 1147A–B and 1148A–B (rejected) placed *in camera* with certain restrictions on their availability to employees of respondents (10382). These documents contain information about Interstate's marketing strategies and techniques, as well as analyses, and, if made public, may be detrimental to Interstate's business (*See* 10382). Interstate's motion was granted and *in camera* treatment was directed until further order of the Commission (10383, 10688).

First National Supermarkets ("National", the parent corporation of Pick N Pay, a Cleveland, Ohio, chain supermarket) has filed a motion for post-decision *in camera* protection for certain documents that it supplied to the parties for use in Docket 9000. These documents contain the formula by which Continental's wholesale prices of Pick N Pay private label bread products are determined, a formula that is used currently. National contends that this formula, as well as current prices charged by Continental, is highly sensitive business information, the disclosure of which to competitors would be detrimental to National's business. All information which is essential to decide the issues in this matter is contained in the portion of the record that will be open to public inspection. Accordingly, to protect the legitimate business interest of Pick N Pay and National, *in camera* treatment for CXs 973 (portion), 974, 975, 976, 978, 979, 980, 981, 982A–B, 984 A–G, 986 A–C, 2602 A–B and 2601 (A–D, rejected) is extended until the date of the Commission's decision in this matter or until otherwise ordered by the Commission.

There does not appear to be any reason to extend *in camera* treatment for any other document of record. Accordingly, the *in camera* status for all other *in camera* documents expires as of the date of this initial decision. [8]

Preliminary Summary of Facts and Contentions

Although a long and detailed recitation of the facts annotated to the record is presented in this initial decision it seems appropriate to set forth a brief summary of the salient facts and the parties' basic contentions as an introduction to those findings.

The principal producers of bread products are either wholesale bakers or chain grocery stores that operate their own bakeries. Some wholesale bakers are multiplant companies operating a large number of bakeries throughout the United States. There are also wholesale bakers that operate in a few or only in one market area.

Bread bakers usually produce a great number of bread products. White bread constitutes, by far, the largest single bread product, and it is considered to be a homogeneous product. The same dough mix may be used to produce loaves of white bread, hot dog rolls and hamburger buns. These white bread products are generally referred to as "white pan bread." Some other bread products such as whole wheat, rye and pumpernickel breads are usually referred to as "variety" breads.

Wholesale bakers sell bread products to retail grocery stores, restaurants and institutions. They usually deliver bread products to the purchasers' stores or places of business. Chain store bakers, called "captive bakers," distribute their bread products exclusively through their own stores. Although production costs are approximately the same for all bread producers, the chain store bakers' costs of distribution are lower than the delivery costs of wholesale bakers. The retail price of captive label bread is usually lower than the retail price of bread baked by wholesalers.

Wholesale bakers sell bread under different labels and at different wholesale prices. The bread products sold under the wholesale bakers' principal trade name are usually called "advertised label." Wholesale bakers sell bread to chain stores that do not have their own bakeries under the stores' label which is generally called "private label" bread. The wholesale price of private label bread is usually lower than the wholesale price of advertised label bread which permits the grocer to sell it at a retail price comparable to the retail price of captive label bread.

Retail grocers, including chains with captive bakeries usually purchase the advertised label of most of the wholesale bakers doing business in a market area. Bread products are displayed in the grocery store on special bread racks. This display is usually referred to as the "bread table." The position and the amount of space on the bread table which a grocer allots to a wholesale baker will determine the volume of that baker's products that are sold at retail in that store. [9]

Grocery stores operating captive bakeries give their captive label bread the largest space and the best position on the bread table. Grocers purchasing private label bread will give that bread product the largest space and best position on the bread table. The wholesale baker supplying a grocer with private label bread customarily will get the next best position on the bread table for its advertised label bread.

The wholesale and retail prices of the various wholesale bakers' advertised bread are usually identical in any particular marketing area. In fact, no wholesaler sells its advertised label white pan bread at a higher wholesale price than its competitors' wholesale price for the same product.

Notwithstanding the growth in population, the overall demand for bread has been static. Over the years the per capita demand for bread has decreased. In fact, the public's preference for white bread has decreased while the preference for variety bread has increased.

In many marketing areas, competition among the chain stores has resulted in low retail bread prices. As the retail price of captive bread decreases, noncaptive chains demand lower wholesale prices for private label bread. As the retail price spread between private/captive label bread and wholesaler bakers' advertised label bread increases, less advertised bread is purchased by the consumer. If one wholesale baker lowers its wholesale price of advertised label to protect its volume in advertised bread, all other wholesale bakers must match the lower price or they soon will face a loss of volume of their sales.

Another method of protecting the sales volume of advertised label, as well as increasing sales volume, is by obtaining a grocer's private label business and the additional sales of advertised label products that result from obtaining favorable space and position on the bread table.

Economies of scale are important in the baking industry and wholesale bakers must operate their bakeries at approximately 80% of maximum possible production capacity (2 shifts and some overtime) in order to obtain maximum efficiency.

As a result of lower wholesale prices, the profitability of the wholesale bakers is affected adversely. Besides lower wholesale prices, the extent of loss of profitability may also depend on a loss of volume of sales or on the percent of a wholesale baker's business that is in private label products.

Complaint counsel contend that in certain marketing areas Continental has lowered the wholesale price of private label bread or advertised label bread below Continental's fully allocated costs for long periods of time and that as a result [10] other wholesale bakers, usually those operating only in one marketing area, have not been able to continue in business. Complaint counsel contend that such practices have been engaged in with the intent of injuring competition and creating a monopoly in an industry that has high barriers to entry. They also contend that the differences in price that result from respondents' pricing practices constitute price discriminations which have the effect of injuring competition and creating a monopoly. For purposes of antitrust analysis, complaint counsel contend that white pan bread baked by wholesale bakers constitutes a relevant product market, and that price discriminations and below cost selling can be measured on particular bread products within that product market (*See generally* CC Mem; CC Reply Br.).

Respondents contend that there is "chronic" excess capacity in the bread industry, usually caused by the backward integration of chain stores acquiring their own baking facilities, thus reducing the space available to wholesale bakers on the bread tables in a market. In this respect they argue that there are no significant barriers to entry into the bread baking industry. They argue that low retail prices of bread charged by the chain stores are the cause of low wholesale prices of private label and advertised label bread. They also contend that the wholesale bakers must compete for whatever space is available on the bread tables of the grocers who do not have captive bakeries and that the wholesale bakers must match the lowest wholesale price on the market. No wholesale baker can unilaterally raise prices. Respondents contend that they never beat other wholesale bakers' prices, but always responded to the prices offered to grocers by their wholesale baker competitors. They argue that it is not improper for a wholesale baker to sell below its fully allocated costs, in that selling at prices above marginal costs contributes to the cash flow and profitability of a baker and that such pricing makes good business sense.

Respondents assert that variety breads are interchangeable with white bread and that captive bread competes with wholesale baker bread. In this respect, they contend that the relevant market is all bread sold by both wholesale bakers and captive bakers. They also contend that wholesale bakers actually sell a line of bread products to grocers and that the product mix of private label and advertised label bread as well as white bread and variety breads, determines the profitability of any customer's account.

Respondents contend that the withdrawal of undercapitalized wholesale bakers that do not advertise their products is inevitable under the market conditions that exist in the bread industry and that such withdrawal is not the result of their pricing activities. Finally, respondents contend that their market share of the bread industry is decreasing and that there is no way that they or any wholesale baker can achieve a monopoly position therein (*See generally* RBr.; R Reply Br.). [11]

Expert Testimony

Both sides presented the testimony of economic experts in support of their respective theories of the case. Complaint counsel's expert witnesses were Dr. Richard G. Walsh, a professor of economics at Colorado State University (8015), Dr. Stanley E. Boyle, a visiting professor of economics and independent consultant (7892), Dr. Rodney D. Patterson, also a professor at Colorado State University (7707), and Dr. Lee E. Preston, a professor of business and public policy at the University of Maryland (11574). Respondents' expert witness was Dr. Michael L. Wachter, professor of economics at the University of Pennsylvania (10386). Only Dr. Walsh has made specific studies of the baking industry, and he published a major work on the subject in 1963 (8017 *et seq.*).

The expert witnesses testified on a number of issues that have been raised in this case including their opinions on market (monopoly) power, relevant product markets, excess capacity, barriers to entry and whether certain pricing practices should be considered predatory instead of being seen as predictable and reasonable business responses to industry conditions. For example, Dr. Wachter testified that in an industry where there was excess capacity and low barriers to entry pricing below fully allocated costs and above marginal costs (or average variable costs) in the short run were to be expected (10421, 10453, 10650). He stated that under such circumstances, predation would not be an economically sound business choice, because it would be highly improbable that the firm could recapture the loss in profits through higher prices in the future (10483, 10625, 10655). In addition, several expert witnesses expressed opinions on whether divestiture would be an adequate remedy if the allegations of the complaint were sustained.

For the most part, the expert testimony is general and theoretical in nature and is not directed to the specific fact situations that exist in the several local marketing areas which have become the subject of this proceeding. In addition, the various opinions seem to be inconsistent in many respects. Accordingly, except for providing some understanding of technical economics concepts, this testimony is not very helpful in assessing the legality of Continental's pricing practices under the several statutes involved. However, it would appear that such expert testimony may be of great value to the Commission when it makes its policy determination as to the future regulation, if any, of respondents' conduct in the baking industry.

Introduction to Findings of Fact

Having reviewed the entire record in this proceeding, and having considered the demeanor of the witnesses who testified at the adjudicative hearings together with the [12] pleadings, admissions, proposed findings, conclusions and briefs submitted by complaint counsel and counsel for respondents, I make the following findings of fact based on the record considered as a whole. Because the record contains much duplication of factual material, not all references possible may be included in the citations to the record, especially where the parties do not differ significantly in their understanding of such facts.

FINDINGS OF FACT

Respondents

1. Respondent ITT is a Delaware corporation with its principal place of business at 320 Park Avenue, New York, New York. ITT is a conglomerate engaged, indirectly and through subsidiaries, in numerous and diverse businesses including, among others: the development, manufacture, distribution, servicing and operation of electronic and telecommunications equipment and other industrial and consumer products; life, fire and casualty insurance; processing wood pulp; mining; business and consumer services; and the manufacture and distribution of food products and automotive parts. In 1973, ITT had sales of approximately $10.2 billion and it was ranked ninth among domestic corporations in the Fortune 500 in terms of sales (Complaint ¶ 2; Answer ¶ 2; CX 2051).

2. Respondent Continental is a Delaware corporation with its principal place of business at Halstead Avenue, Rye, New York. Continental is a wholly owned subsidiary of ITT which acquired it in 1968 from its predecessor, Continental Baking Company. Continental is engaged in the manufacture, sale and distribution of bread, cake, snacks such as potato chips, frozen prepared foods, candy and ingredients for the baking industry. In 1972, Continental's net sales were approximately $865 million (Complaint, Answer ¶ 3). If it had been a separate entity, Continental would have been ranked 177th in the "Fortune 500" in terms of sales (CX 2051). In 1972, some of Continental's subcompanies or divisions were Morton's Frozen Food, Pearson Candy Company, Gwaltney (meats), and Panaplus (ingredients) (9905 Dierker).

3. In 1973, Continental baked bread in 48 bakeries located in 30 states and the District of Columbia and distributed it through over 300 depots to areas of 46 states. In 1973, Continental's sales of bread were approximately $445 million and the 1973 dollar sales of bread

were about 35% above its 1968 annual sales (*See* Complaint, Answer ¶ 11).

4. Continental Baking Company was founded in 1924 by the consolidation of 90 baking companies (463 Woodward). By 1978 Continental had 61 plants, 31 of which baked bread exclusively and 7 of which baked cake exclusively (468 Woodward). Since 1924, Continental Baking Company and its successor Continental have been the largest bread baker and snack cake baker in the [13] United States (464, 472–73 Woodward). In 1974, Continental's geographic coverage for bread products was approximately 70% of the U.S. population (471 Woodward; CX 116C). It served approximately 80% of the U.S. with cake (CX 116C).

5. In the early 1970's Continental's bakeries were grouped into 7 regions which are sometimes identified by the location of the regional office: New York, Atlanta, Detroit, Chicago (2), San Francisco, Los Angeles (473–79 Woodward). Each functional official at the bakery level *i.e.,* bakery manager, bakery sales manager, etc. has a counterpart at the regional level to whom he reports (474, 478, 480–81 Woodward; *see* 3164–65 Frielink). The regional office personnel have staff functions instead of line functions. The regional vice president has profit responsibility for his region (473 Woodward). Each regional vice president transmits a monthly management letter to the President of the Bakery Division in Rye, New York (479 Woodward).

6. Continental's Rye Headquarters purchases all major commodities (ingredients) used by its bakeries. It also prepares advertising copy and places advertising with various media. New product development and laboratory work is performed by headquarters personnel. Rye personnel also assist the various regional offices with labor negotiations, in making sales to national accounts, or multiple outlet accounts, and in making sales to certain "institutional accounts" such as hotel chains and military installations (660–61 Meyn).

7. Continental has a very sophisticated money management system by which the cash generated at the various plants is withdrawn each day and moved to Rye, N.Y. and then to ITT in New York City (1324–25 Willmont).

8. The day-to-day accounting is conducted at the individual plants and the results are combined or summarized at the regional offices and forwarded to Rye headquarters (490 Woodward). Since 1973, Continental has employed a Standard Cost system in its individual bakeries. Before implementation of this cost system, Continental developed estimated costs from a test cost program (528–29 Woodward).

9. Continental produces a full line of bread and "snack cake" products (467 Woodward). Continental's bread labels include Wonder, Home Pride Butter Top, Fresh Horizons, Country Fair and Country

Style (467, 493–94 Woodward). Continental's cake labels include Hostess and Twinkies (467–68 Woodward).

Continental's Wholesale Competitors

10. After Continental, the largest wholesale baking companies in the bread industry are Campbell-Taggart, American Baking Company ("American"), Interstate Brands Corporation ("Interstate"), Flowers Bakery and Metz Baking Company (514 Woodward). Today, Continental, Campbell-Taggart and Interstate are the "primary national bakers" (CX 4 (116)). [14]

11. Campbell-Taggart was formed as an offshoot of Continental in the late 1920's. In 1974, it had approximately 70 bakeries (CXs 69R, 2107). Many of these bakeries were located in the smaller cities of the South, Southwest, Midwest and Far West (CX 3 (105); *see also* CX 69R, Z–20). Campbell-Taggart serves approximately 30% of the U.S. population (CX 69F). Continental and Campbell-Taggart generally do not sell in the same geographic markets, although major overlapping markets are San Francisco, Denver, Sacramento, Kansas City, Memphis and Indianapolis (CX 3(105); *see also* CX 69R, Z–20). Although Campbell-Taggart performs in-depth services for the various functional departments of its bakeries, the local baking subsidiary companies operate as separate legal entities (CX 69Z–15; 1006–6 Z Mackaman). Campbell-Taggart's labels include Colonial, east of the Mississippi River, and Rainbo, Manor and Kilpatrick, west of the Mississippi River (10063–65 Mackaman; CX 2107). Continental has rated Campbell-Taggart as "excellent" in product quality and management (*See* CX 2107).

12. American operates approximately 20 plants located generally in the Northeastern, Central and Southwestern parts of the United States (CX 2107; *see also* CX 9 (204)). In 1973, Continental considered that American was "retrenching" and in 1979 Continental regarded American as the weakest of its national competitors (CXs 2107; 8 (038)). American's labels include Tastee and, on the west coast, Langendorf (8855 Murray).

13. Interstate operates approximately 30 bakeries located in the Eastern, Central, Southwestern and Northwestern United States (CX 2107). In 1973, Continental considered that Interstate was "retrenching" (CX 9 (154)). Continental generally regarded Interstate as a weaker competitor than Campbell-Taggart, but considered it to be strong in marketing approach and creativity (CX 2107; *see* CXs 2 (087); 4 (133)). Interstate's labels include Millbrook, Butternut, Weber and Blue Seal (3942 Heuter; 4706 J. Walsh).

14. As late as 1972, Ward Baking Company had 15 bread producing plants but was not regarded by Continental as a strong competitor

(CXs 2 (087); 4 (133); 9 (204)). Apparently Ward is no longer considered to be in the bread baking business (9425–26, 9376, 9532 Gase).

15. Flowers serves the Southeastern United States from approximately 21 plants. Continental regarded Flowers very highly (CX 2107). During the times relevant in this case, Flowers and Continental apparently did not compete in the sale of bread products, at least not in the six marketing areas studied in this case (*See* 514 Woodward; 10267 Jakaki).

16. Metz has approximately 14 bakeries located in the North Central region of the U.S. (10200 Metz). Its principal label is Old Home (10201 Metz). [15]

17. Major bakery cooperatives are Quality Bakers of America ("QBA"), W. E. Long, and American Bakers Cooperative (8053–54 R. Walsh; 514–15 Woodward). These cooperatives are management service associations organized on a nonprofit basis to provide the kind of services that a multiplant corporation might provide to its individual plants, including counseling services on production, engineering or accounting problems. Many independent bakers belong to cooperatives (8053 R. Walsh; *see* CX 3 (108); 10266–69 Jakaki; 11199 Schaus). The cooperatives also have advertised labels. Members of QBA can use the label Sunbeam and members of W. E. Long can use the label Holsum in many marketing areas (490–91 Woodward; RX 1039).

18. It is estimated, based upon information supplied by wholesale bakers to the Commission in 1970, that the shares of the national wholesale bakers' bread and bread type rolls national market were as follows: Continental 14.2%; Campbell-Taggart 9.7%; American 7.9% and Interstate 5.6% (*See* RX 1042 *in camera*).

Captive Bakers

19. In addition to the wholesale bakers, many retail grocery chains operate their own bakeries and produce bread which they sell in their own retail outlets (10208–09 Metz). In some marketing areas the chain store or "captive bakers" may be the largest producers of white pan bread.

Bread Baking

20. The bakery products produced by large wholesale bakers include white bread, hamburger buns and hot dog rolls, variety and hearth breads such as whole wheat, rye, pumpernickel and raisin breads, brown and serve rolls, specialty rolls such as Parker House rolls and English muffins, French bread, bread stuffing, snack cakes, doughnuts, pastries, sweet rolls and fresh pies (RX 1000C&E). White pan bread ("white bread") is white bread that is baked in a pan to the standards set by the government and it is considered to be a homo-

geneous product no matter who bakes it (499–500, 508 Woodward; *see* 7909 Boyle).

21. White pan bread is produced by either a conventional process (which entails the mixing of each batch of dough separately) or a continuous mix (which permits a continuous mixing of the dough) (518–19 Woodward). Although the continuous mix process became popular in the 1960's, the present trend is back to conventional mix process because it is more flexible in the production of variety breads and because it produces white bread, the texture of which may have better consumer acceptance (519–20 Woodward; *see* 3358–59, 3396 Frielink).

22. In the conventional mixing process, a sponge is produced. It ferments. Other ingredients are added after **[16]** fermentation. The mixture is then passed through equipment to be scaled, divided and placed in a pan to be baked. In the continuous process the ingredients are fed into a mixer or processing unit. The dough continues in a steady stream without fermentation, then it is scaled, divided and placed in a pan and baked (724 Meyn). Hearth breads are baked on a hearth, that is, a solid surface. Regular pan bread is baked in a pan on a shelf oven over a flame which is applied to the pan (724 Meyn). Continental uses special pans to produce hearth type breads (725 Meyn). Continental also uses a "brew system" which enables it to produce bread with properties of the conventional mix process by the continuous mix method (3199–3200, Frielink).

23. Economies of scale are important in the baking industry and wholesale bakers must operate their bakeries at approximately 80% of maximum production capacity (2 production shifts and some overtime) in order to obtain maximum efficiency (11204–05, 11223–24 Shaus; *see* 10295, 10300 Jakacki). Independent wholesale bakers are generally as efficient, if not more efficient, than the large multiplant wholesale bakers (11199–11200 Shaus).

Bread Distribution

24. Continental and other wholesale bakers sell bread principally to retail grocery stores. Wholesale bakers also sell to restaurants, hotels, institutions, and other customers (467–68 Woodward). It is estimated that Continental's sales to restaurants and institutional accounts, which consisted predominantly of buns and rolls was approximately 13% of its total route sales (RX 1039; *see also* CX 2361 B).

25. Continental and most other wholesale bakers distribute bread though a system of route salesmen who deliver bread to retail grocery stores and restaurants. These route deliveries are made from the bakery or from depots or agencies to which bread is transported in

large trailer trucks from the bakery for transfer to route trucks (482–3, 525 Woodward; 3167 Frielink).

26. Bread is usually sold on a guaranteed sales basis, that is, the wholesaler takes back loaves that are not sold within a few days. These loaves are called "stales" and the service is called "stale return." Sometimes bread is sold on a "no return" basis at a lower wholesale price (*See, e.g.*, CXs 207; 1714F; 1515 Z–95). Bread that is returned is usually placed in the bakery "thrift store" for resale at a reduced price (664 Meyn) or sold to farmers as feed (1120–21 Brout). Continental sets 48 hours as the shelf life of its Wonder label bread (726 Meyn; 1120 Brout). The driver-salesmen provide "rack service" to grocery stores. They physically place the fresh bread on the grocery store shelves two or three times a week and take away the stale returns.

27. Driver salesmen are members of the Teamster Union. Most union contracts provide that their compensation be based on [17] a certain salary plus commission. Chain store bakers usually distribute bread products by semitrailer to the "door" of their retail outlets; the bread is placed in the grocery shelves by store employees. Drivers of semitrailers usually belong to a different "local" of the Teamsters Union. They are paid on a straight hourly rate (726 Meyn). Generally, the costs of producing white bread are uniform among bakeries, but chain store bakers enjoy a distribution cost advantage because of the difference in delivery methods (*Id.;* CX 22(ii); 902–03 Stolle).

28. Because of the relatively small area that a bakery can serve with fresh bread, bread is marketed and sold on a local basis. No major baker competes in every market. The competitive conditions, price levels, identity and number of competitors differ from marketing area to marketing area. The pricing in one market generally has no direct impact on prices in other markets. There is no dispute that the relevant geographic markets are generally local (Answer ¶ 6).

29. Most wholesale bakers, including Continental, market an "advertised label" or "primary label" line of bread products sold under the brand name owned and usually promoted and advertised by the wholesaler. "Wonder" is Continental's principal advertised brand and accounts for the bulk of Continental's white bread sales (RX 1039 (*in camera*); 490–91 Woodward; *see* 649 Meyn).

30. Continental and many other wholesale bakers also sell bread packaged under the "private labels" of retail grocery chain stores. The brand name is owned by the retailer and the retailer promotes and advertises the bread. Wholesalers sell private label bread at lower wholesale prices than their advertised label, and private label bread is sold by the retailer at a lower retail price than advertised label bread (490–98 Woodward; *see* 727 Meyn). A private label program

usually includes at least the popular size loaves of white bread, hot dog rolls and hamburger buns (3177–78 Frielink; 4537 A. Gordon; 4734 J. Walsh; *see e.g.*, CX 1526B–C).

31. In addition, wholesale bakers sometimes sell "secondary" label bread. Secondary label bread usually sells at a price comparable to private label and is often provided to independent grocers that are too small to have an economical private label program (491, 494 Woodward; 650-51 Meyn). Some wholesale bakers will supply bread to a retail chain store packaged in a "controlled" label owned by the wholesale baker to which that chain store customer is granted exclusive use in a particular marketing area (650 Meyn; 4148 Heaps). Controlled label bread is usually sold at a private label wholesale price (*Id.*).

32. Bakeries owned by retail chain stores are called "captive" bakeries and the bread baked and sold in the chain's [18] retail outlets is called "captive label" bread. It is estimated that 50% of the white bread produced and sold in the U.S. is sold under either private label or captive label (604 Woodward).

33. Shelf position and the amount of shelf space in the retail grocery store are the most important factors in the marketing of bread, in that a better shelf position will sell more bread and larger shelf space will sell more bread (504–05 Woodward; 690–91 Meyn; 854–55 Vail). In addition, the consumer franchise (consumer acceptance of the labeled product) is an important factor. The grocer determines the allotment for bread shelf space among his various suppliers (652–53 Meyn). A preferred position for bakery products is the position that is exposed to the major flow of traffic past the bakery products display (656, 692 Meyn). It is customary for a grocer to allot the preferred position and the largest amount of shelf space to his private label bread and the next best position to the supplier of that private label bread which the supplier will use to merchandise his advertised label (506–08 Woodward; 656 Meyn). Chain stores with captive label bread will allot the preferred position and the largest amount of shelf space to the captive label bread (10137–38 Nissen; 10210–11 Metz).

34. Most grocers including chains who have their own bakery will usually carry a limited quantity of the advertised labels of all the wholesale bakers selling in a particular marketing area in order to meet consumer demand. Restaurants and institutions, on the other hand, usually purchase bread products from only one wholesaler.

35. Although all white bread is virtually a homogeneous product with regard to quality, nutrition, palatability and physical features, wholesale bakers, by advertising their primary label bread, are able to create a consumer franchise for their brands. Because of this consumer franchise, a retail grocer is able to sell advertised white bread

at a higher retail price than brands that do not have a consumer franchise (CX 104; *see* 8184 R. Walsh).

36. Historically, the retail price of captive label bread is below the price of advertised label bread, and private, controlled, and secondary label breads are used by chain stores, which do not have their own bakeries, to compete at the retail level with the captives. Wholesale bakers sell bread products under private controlled and secondary labels at a lower wholesale price than the wholesale price of advertised label. A large retail price spread between captive and private label bread, on the one hand, and advertised label bread, on the other, will result in a loss of sales of advertised label bread. If this price spread is reduced the captive and private label products will lose sales and there will be an increase in sales of advertised label bread (*See* 10139 Nissen; 10239–40 Metz). [19]

Bread Industry Trends

37. During the 1960's and 1970's, the bread industry has enjoyed little, if any, growth (522, 605 Woodward; 1022 Sweeney), and in recent years the per capita consumption of bread has decreased (522, 605 Woodward; 10088 Mackaman; 11224 Schaus). The market for standard white bread has declined from 8,808 million pounds in 1967 to 8,657 million pounds in 1972, and further decreased to 7,327 million pounds in 1977 (CX 1355, (E-15); RX 1000E). White bread has accounted for an increasingly smaller portion of total bread sales. White bread represented 79% of all bread sold in 1947, 61% in 1967, and 59% in 1971 (CX (178, 192)). On the other hand sales of variety breads have increased (10162 Nissen; 10231 Metz; 11234 Schaus).

38. Although total white bread sales have decreased, the total of private and captive label bread sales have grown. In this respect the private and captive label share of white bread sales nationally increased from 18% in 1960 to approximately 36% in 1971, and Continental expected that that captive and private label share of the white bread marketshare would increase to 50% by 1977 (604 Woodward; CXs 4(130), 21(9); 94A). In 1971, Continental estimated that one third of the white bread that was not sold under an advertised label of wholesale bakers was baked by captive bakers, while two-thirds was private label bread baked by wholesale bakers (CX 4(130)).

39. The cost of ingredients and labor increased sharply during the early 1970's. Because Federal Price Controls often precluded commensurate wholesale price increases, numerous small bakers were forced out of the market by the resulting cost-price squeeze (8992–94 Brown; 1020–05 Metz; 10132–33 Nissen). As many as 140 independent bakers withdrew from the market in the 1972–1974 period (10205 Metz; *see also* 11214 Schaus). Between 1969 and 1974, 83 bread baker-

ies that competed in the areas served by Continental went out of business (CX 37C).

40. Individual geographic markets in the bread industry are highly concentrated. According to Continental's 1972 Business Plan, in 75 Markets surveyed, the average white bread market share of Wonder and the leading wholesale baker competitor was 59.7%, in a universe that included private label and captive label bread. Excluding private label and captive label bread, the average two-firm share in advertised label white bread would be over 75% (*See* CX 4(131)).

41. There have been few new entrants into the wholesale baking industry during the 1970's (*See* 10171 Nissen; 10282–83 Jakacki). The number of captive bakers, which grew dramatically in the 1960's, has decreased in the 1970's (10140–42 Nissen; 10202–03; 11230–31; 11236, 11243 Schaus).

Continental's Sales and Profits

42. Although Continental's share of total bread sales on a national basis has not increased, but remained between 11% and [20] 12% from 1967 to 1977, its advertised label's share of the overall white bread market increased from 15.4% in 1975 to 20.1% in 1978 (*See* CXs 1355; 2162B; (*in camera*); RXs 1000; 1142 (*in camera*)). Respondents estimated that as of February of 1973, Continental had a 32.7% share of the *advertised label segment* of the white bread market (CX 9(203); CX 1371B).

43. Continental's dollar sales of all bread products increased from $309 million in 1967 to $609 million in 1977. Continental's pretax profit on bread as a percentage of sales for the period 1964 through 1977 were as follows (RX 1142 *in camera*):

1964	4.5
1965	3.8
1966	4.6
1967	5.1
1968	4.8
1969	4.5
1970	5.7
1971	4.1
1972	(0.5)
1973	(1.5)
1974	0.5
1975	2.3
1976	0.9
1977	3.0

Continental's Costs

44. Before 1973–1975, when it installed a Standard Cost Accounting system, Continental did not maintain ongoing records of the cost incurred in producing particular varieties or labels, but instead maintained records on the total costs for the weekly operation of each bakery. Continental did attempt to estimate the costs of producing any new variety or label on its Form 452B (*See* 9688–93, 9887 Dierker).

45. The bread industry has a relatively low ratio of fixed to variable costs (10486–87 Wachter; 11633 Preston). Apparently, Continental's variable costs in 1971 were approximately 80% of its revenues (*See* CX 262D (*in camera*); CX 747 (*in camera*); *see also* CX 2104–Z–24). For purposes of this initial decision, it will be assumed that Continental's variable costs were 80% of its total allocated costs. Distribution and selling costs for wholesale bakers were relatively high. For example, in 1973, Continental's distribution costs were 35% or more of the total costs on all route sales of bread (CX 58B; CX 106; CX 747 (*in camera*)).

Market Shares

46. Each year Bruskin and Associates, an independent research organization, conducts a telephone survey for [21] Continental in most of the markets where Continental competes in the sale of bread products (768 Hackett; 595–98, 602 Woodward). The purpose of this study is to ascertain bread producers' share of the markets, including private label and captive label bread, and to generate market trend information (768 Hackett; 630 Woodward). Although these studies tend to understate private label shares, they are fairly accurate measures of market shares on a national and regional basis and are relied upon by Continental to determine competitors' shares of individual markets. However, the samples are too small to provide accurate market shares for a local market and should be used only to determine trends in such markets (*See* 771–72 Hackett; 602, 614, 630 Woodward). The Bruskin studies (sometimes referred to as "Bread Metrics" (CXs 135–143)) form the basis for most of the market share data that appear in Continental's business reports and planning documents (*See e.g.*, CXs 11 (137); 2167B (*in camera*)).

ITT's Involvement

47. After it became part of ITT in 1968, Continental changed its reporting, business planning and budgeting systems to conform to ITT's methods (1328–29 Willmont). Continental became subject to ITT's high growth philosophy (896–97 Stolle). ITT's influence made Continental's management more responsive and alert to identifying

opportunities and problems. Woodward, Continental's president during the early 1970's, stated (636 Woodward):

> *** ITT's strength is an extremely effective management system. We are working very closely with ITT headquarters and its staff. ITT is a good risk taker, provided you effectively support your plan. They have made us more aggressive in our outlook toward opportunities . . . ITT expects its units to grow 15% a year in profits.

ITT personnel with oversight responsibilities for Continental were aware that the growth in private label bread was preventing Continental from meeting its growth objectives (CX 25A–C; *see* CXs 3(091); 5(018)). ITT was directly involved in establishing strategies for gaining additional private label sales and in evaluating Continental's pricing strategies (CXs 90J; 128B; *see* CX 58B). ITT knew that Continental sold private label products below cost (CX 94B–D).

48. In May 1971, ITT initiated a study to investigate the impact of private label (including captive label) merchandising upon Continental's bread business (796, 802 Butler). The primary purpose of the study was to generate an independent confirmation of Continental's internal strategies and to gain information on captive label businesses including their inside manufacturing costs and their distribution costs (761 Hackett; 802 Butler; 916 Stolle). McKinsey & Co. was chosen to conduct this study because they had good business relationships with a [22] number of retail chain stores (908 Stolle). Although Continental was attempting to meet the problems of captive label merchandising, ITT did not think it was doing enough (913–14 Stolle).

49. McKinsey personnel held many conferences with Continental personnel (805 Butler). At one such meeting, according to notes taken by R. Ronald Daniel, the McKinsey partner responsible for the study, the question arose as to whether Continental should hold the line on prices in hopes of driving weaker competitors from the market (CX 28S; *see* CX 28T). In the final report submitted to ITT in October 1971, McKinsey identified a number of issues that warranted further intensive analysis, one of which was the question of whether "holding retail prices [would] hasten the exit of wholesale competitors?" (CX 21 at 3–3; *see* CX 20Z–51–Z–63). According to Continental officials, Continental did not adopt any new strategies as a result of the McKinsey report (607 Woodward; *see* 1349–50 Willmont).

Denver Marketing Area

50. Complaint counsel challenge certain pricing actions engaged in by Continental in the Denver, Colorado, area during the period 1963 through 1969. More particularly, complaint counsel challenge Continental's private label agreement with Associated Grocers, a voluntary cooperative of independent grocers, and the effects of sales made

pursuant to that agreement upon competition among wholesale bakers in the Denver area (CCPF 8-1-8-193; CC Mem. 71-95).

51. Continental's Denver bakery was part of its Southern California (Santa Monica) region which also included bread bakeries located in San Diego, San Pedro (DiCarlo), Beverly Hills and Salt Lake City (4677-78, 4693-94, 4751 J. Walsh).

52. The other major wholesale bakers selling white bread in the Denver market were Interstate, Campbell-Taggert, Old Homestead and Star Bread Company (6986 Downing). Star was primarily a baker of variety bread and it was not a great factor in the white bread market (6863-66 Downing). All white bread sales in the Denver market were made from plants located in that market. *Continental Baking Co.* v. *Old Homestead Bread Co.*, 476 F.2d 97 (10th Cir. 1973), *cert. denied*, 414 U.S. 975 (*"Old Homestead"*).

53. Continental's Denver bakery sold products, including white bread, in most of Colorado, Southeastern Wyoming and Southwestern Nebraska (CXs 1401E; 1427G; 1718Z-37 Ward).

54. In the late 1950's, Continental operated bakeries in Denver and Pueblo, Colorado (CX 1723D Barsch). In 1962, Continental replaced these two plants with a new bakery located in Denver (6864 Downing; CX 1723H Barsch). This new bakery was twice as large in floor area and could produce twice the amount [23] of bakery products as its two old bakeries combined (RX 831Z-7, Z-16 Hildebrand). When it began operations, the new bakery produced at a rate of 33 million pounds of bakery products per year, which was only at 50% of its capacity (*Old Homestead, supra,* 104). In 1962, Continental's Denver plant sustained a loss of $600,000 (CXs 1401F; 1427K).

55. During the period 1960 to 1968, the Denver bakery produced bakery products under the following labels: Wonder, Tender Crust, Oak Farm, County Fair, Home Pride, Daffodil, Profile, Frenchef, Mrs. Wright's, Jills and Hostess (CXs 1427E; 1401B). It sold private label bread to Associated Grocers, Red Owl and Southland Corporation (7-11 stores) (CXs 1423B-7, B-56, N-71-72 Vanwyk).

56. Interstate had entered the Denver market by acquisition in the late 1950's and built a new plant which was completed about 1960 (6863, 6984, 6986 Downing). Its main advertised label bread was Butternut (6863, 6887-88 Downing).

57. Campbell-Taggart built its Denver plant some time in the 1950's (6986 Downing). Its advertised label bread was Rainbo (6865, 6887-88 Downing).

58. Old Homestead, established in 1892, was a pioneer in the Denver bakery market (6852-53 Downing; CX 1706N Roberts). For many years it enjoyed excellent shelf position in grocery stores because it was owned and operated by the Downing family of Colorado (7368

Rheinfrank; 7075 Tipton). In 1962, Old Homestead changed its baking process from the conventional mix to continuous mix process and as a result it became very efficient in white bread production (6859–60 Downing). Old Homestead also operated a bakery in Colorado Springs (Star Baking Co.) and a bakery in Cheyenne, Wyoming (7048–50 Downing, Jr.).

59. Star, (not to be confused with Old Homestead's subsidiary of the same name), which was primarily a variety bread baker, was the leading wholesale baker in sales to restaurants and institutions (7099 -7101 Cauble).

60. In 1963, the total of independent wholesale bakers' sales in the Denver market was approximately $14 million. Continental had the largest share with about 35%, Old Homestead was second with about 29%, Campbell-Taggart had about 18% and Interstate about 16% (*Old Homestead, supra,* at 105).

61. Safeway, King Soopers, and Millers were major grocery store chains in the Denver area that operated their own captive bakeries (6873–78 Downing; 7082–3 Tipton). It was estimated that these three chains accounted for about 75% of the grocery retail business in the Denver market (6878 Downing; 7237–38 Johnson). In volume of white bread sales, the bakery operations of King Soopers and Safeway were larger than the combined volume of all the wholesale bakers (7663 Stevens). [24]

62. The largest selling size of white bread in the Denver market was the 1 lb. expanded loaf (7326 Aldrich).

63. Before 1964, wholesale bakers did not compete on the basis of the wholesale or retail prices of their products (7629 Stevens; 7087 Tipton). There were meetings or communications between them prior to any price move, which all the wholesale bakers took at the same time (6971–73 Downing). Competition among wholesale bakers was usually limited to salesmen's personalities and their relations with various grocers (7614, 7628–33 Stevens). The wholesale price of 1 lb. white advertised bread fluctuated between 16¢ and 20¢ during the early 1960's and, in July 1964, the price was increased to 20.5¢ (CX 1477A–C).

64. The relative stability of wholesale price from 1960 to 1964, combined with rising costs of production, caused Old Homestead to operate at a loss of approximately $83,000 in 1964 (CX 1510B; 7573–74 Williamson).

65. Before July 1964, none of the wholesale bakers sold private label bread (*Old Homestead, supra,* at 102). In the early 1960's, when Red Owl entered the Denver retail grocery market, it sought a private label program, but no wholesale baker was willing to bake private label for Red Owl (6963–64 Downing). Red Owl acquired a baking

facility and produced its own bread until early 1965 (6963–64 Downing).

66. Associated Grocers is a cooperative of independent retail grocery stores. It was formed to purchase in quantity for its members and it performs wholesaler and other functions for its members (7470–71 McCutcheon; 6878 Downing). In 1960, grocers paid an entry fee in the nature of a deposit to join Associated Grocers and application approval was made by its Board of Directors on the basis of financial condition, location and accessibility for delivery. Some applications for membership were turned down (7472 McCutcheon; 7181 Johnson).

67. Although the majority of the Associated Grocers members were located in Colorado during the 1960's, it also served grocer-members in Wyoming, Kansas, Nebraska and New Mexico (7471 McCutcheon). Associated Grocers' members accounted for about 4% of the retail grocery business in the major cities in the Denver area, including Boulder and Colorado Springs (7293–94 Johnson).

68. In 1961 and 1962, Associated Grocers advised the wholesale bakers in the Denver area that it was interested in obtaining either a private label program or in acquiring and operating its own bakery (7185–87 Johnson). Although at first all the wholesale bakers refused to supply private label bread, in late 1963 or early 1964, Interstate began serious private label negotiations with Associated Grocers (7186, 7246–47 Johnson). When Continental learned of these negotiations, Ralph Ward, Regional Vice President, contacted Lenhard Johnson of Associated Grocers and began negotiations for a private label program (CX 1718 R. Ward; 7248, 7257 Johnson). [25]

69. On July 1, 1964, Associated Grocers organized a company named Five States Supply Company ("Five States") for the purpose of the private label bread program. In practice, only members of Associated Grocers could become members of Five States. They were charged a $100 refundable membership fee per store and were required to agree to comply with the Five States Bylaws (CX 1519; 7183–84, 7300 Johnson). Five States had no separate employees, offices or facilities and operated through Associated Grocers which handled its billings and payments (7183 Johnson; 7473 McCutcheon).

70. The private label bread supplied to the Five States members was labeled "Tender Crust", Five States having secured exclusive use of this trademark (CX 1522D). The Five States Bylaws provided that the member grocers would exert their best efforts to sell the Tender Crust labeled products, would give first position on the grocers' regular bread rack to Tender Crust label bakery products, would give second position to the advertised label of the wholesale bakery supplying Tender Crust products, and would price Tender Crust products at the

same retail price as any other comparable bread product (CX 1522D–E).

71. Under the date of August 10, 1964, Continental entered into a written agreement with Five States to supply its member grocery stores with private label Tender Crust and other bakery products (CX 1526). That document provided, in pertinent part, that Five States (CX 1526 B):

> 4.***[agrees] to make available to [Continental] preferred space on [its] member bakery products racks for the display of [Continental's] regular Bread, Cake and Sweet Goods products so that the full sales potential of these advertised brands can be realized. [Five States further agrees] in requesting [its] members to cooperate with [Continental] in arranging special weekly promotions on said advertised bread items.
>
> 5. Deliveries of all products to [its] member stores pursuant to this agreement shall be made by [Continental's] regular Wonder and Hostess route salesmen from their regular delivery trucks. ***

72. Private label products were to be the 1 lb. expanded white bread, the 1 1/4 lb. round top white bread, 1 1/4 lb. sandwich bread and hamburger buns and hot dog rolls. The agreement provided for three methods of delivery at different prices. For example, the wholesale price for 1 lb. expanded bread with stale returns was 17.5¢; with no stale returns was 16¢ and on a store drop shipment was 15¢ (CX 1526 B, D. ¶¶ 7, 8, 9). At that time the wholesale price for Wonder 1 lb. expanded white bread was 18.5¢ (*Id.*). [26]

73. Paragraph 12 of the agreement provided that the wholesale price set by Continental would rise if any general price increases of controlled label bread occurred in the market (CX 1526D). Paragraph 13 of the agreement provided (CX 1526D):

> In the event prices on any of [Continental's] regular advertised products shall, in response to a general price decrease in any market, fall below the prices in effect as of June 1, 1964, then any private label price set forth in paragraphs 7, 8 and 9 shall be reduced in that market to a price at least one cent below the prices on [Continental's] comparable advertised item.

74. The Tender Crust program, including prices, were always conducted under a written agreement and each agreement was in effect until amended (7199 Johnson). After 1964, all deliveries included rack service with or without stale returns (7203 Johnson).

75. Continental obtained the Tender Crust business because it was willing to enter into a written agreement with Five States (7265–66 Johnson).

76. During the 1960's Continental representatives were invited to and frequently attended meetings of Five States Board of Directors (7213–14 Johnson). In 1964 and 1965, Five States newsletters urged

Associated Grocers members to join Five States and to participate in the Tender Crust program (CX 1518G). Continental personnel served as liaison with Five State members and helped them with bread rack arrangements and solicited new members (7211 Johnson). During the 1960's, Continental wrote, typed, made copies, and mailed the Five States newsletters. Five States would supply Continental with information for its newsletter. Paper for the newsletter was kept at Continental's Denver plant (7209, 7213 Johnson).

77. The newsletter advised Five States members of the retail prices on Tender Crust, of the weekend specials and also urged the Tender Crust grocers to maintain those retail prices (CX 1518A–Z–25).

78. At the beginning of the Tender Crust program all labels of comparable bread were identically priced at retail. The wholesale price of Tender Crust was by contract, lower than the price of the other labels (7221 Johnson; CX 1723–Z–5 Barsch). The automatic one cent price differential between Wonder and Tender Crust was created to discourage other wholesale bakers from attempting to compete with the Tender Crust program (7233 Johnson).

79. In September of 1966, Campbell-Taggart began selling a white bread loaf under the label Rainbo Buttermilk at the same price as Tender Crust. Pursuant to its agreement with Five [27] States, Continental granted a 6% discount so that the wholesale price of Tender Crust would be below the wholesale price of Rainbo Buttermilk (CX 1727Z–66–67 Vanwyk).

80. At other times the difference in price between Wonder bread and Tender Crust bread was more than one cent (CXs 1537, 1539, 1549). A 1967 agreement between Continental and Five States provided for a 3¢ differential and a 2.25% central billing discount on Tender Crust purchases (CX 1571).

81. In September 1967, Continental, in response to a 10% discount offered by Campbell-Taggart, instituted its "sliding scale discount" on sales of Tender Crust products. Discounts of 7%, 9% and 11% were granted on certain volumes of purchases. The wholesale list price of Wonder bread was 1¢ greater than the wholesale list price of Tender Crust and a 2% central billing discount was in effect on Tender Crust purchases (CX 1549B). On November 6, 1967, the wholesale price of 1 lb. Wonder bread was reduced from 21¢ to 16¢ and the wholesale price of the comparable loaf of Tender Crust was reduced from 20¢ to 15¢ (CX 1652 Z–47).

82. On November 16, 1967, the wholesale price of 1 lb. white bread to Continental's other private label customers was reduced from 20¢ to 15¢ (CX 1652Z–50). To grocers entitled to 11% discount and the 2% central billing discount, the net price was 13.05¢, or an 18.4% price differential compared to the 16¢ Wonder bread price.

83. Complaint counsel's chart showing Continental's wholesale prices and the percent of differential between Wonder bread private label bread is incorporated into this initial decision, as it appears on the following page. [27a]

Net Prices (in cents) of the One Pound Loaf of WPB Produced by CBC Under the Wonder, Tender Crust, Red Owl, Gem, Oak Farm, Magic Bake, and Janet Lee Labels in the Period 1964-1969.

Date	Wonder	Tender Crust	Oak Farm	Red Owl	Gem	Magic Bake	Janet Lee	Price Difference (cents)	% of Price Difference	Source
July 1964	18.5	17.5 (Plan 1) 18 (Plan 2) 15 (Plan 3)						1 2.5 3.5	5.4 13.5 18.9	CX 1526
Oct. 1965	17.5	16.5						1	5.7	CX 1727-Z-27 CX 1652-Z-5
Mar. 1966	19	18						1	5.3	CX 1652-Z-11, 13
July 1966	21	20						1	4.8	CX 1652-Z-13, 15
Sept. 1966*	21	18.8						2.2	10.5	CX 1537
Oct. 1966**	21	18.4						2.6	12.4	CX 1539
Aug. 1967	21	18.4	20	20				2.6	12.4	CX 1553A
Sept. 1967***	21	18.2 (7% & 2%) 17.8 (9% & 2%) 17.4 (11% & 2%)						2.8 3.2 3.6	13.3 15.2 17.1	CX 1549
Nov. 1967***	16	13.65 (7% & 2%) 13.35 (9% & 2%) 13.05 (11% & 2%)	15	15	15			2.35 2.65 2.95	14.7 16.6 18.4	CX 1549 CX 1652-Z-47, 50
Jan. 1968	21	18	18	18	18			3	14.3	CX 1652-Z-53,55
Mar. 1968	17	13.05****				13.05****		3.95	23.2	CX1696D CX 1578
Sept. 1968	20						18	2	10	CX 1650
April 1969	22						17.,6	4.4	20	CX 1649
July 1969	18	15.7						2.3	12.8	CX 1577

* CBC's 6% discount on Tender Crust
** CBC's 2% discount on Tender Crust
*** CBC's sliding scale discount on Tender Crust
**** Tender Crust and Magic Bake subject to discounts of 10% and 3%

[28] 84. The Tender Crust weekend specials were in effect from the original Tender Crust agreement of August 1964 through at least 1970 and were offered by Continental every week (7205–06 Johnson). At first they were offered under the Wonder label, and later, at the request of Five States, under the Tender Crust label (7207–09 Johnson). Some of these specials were bread items, such as sandwich or wheat loaf or hot dog rolls and hamburger buns (CX 1699E; 7023–24 Downing; 7206 Johnson). These specials were offered at reduced wholesale prices and were sold at retail at reduced prices (CX 1518; *see e.g.*, 7207 Johnson).

85. In the third quarter of 1967, Continental's total cost for the 1 lb. expanded loaves of Wonder bread and Tender Crust white bread were 19.62¢ and 16.59¢, respectively (CX 1722Z–19–Z–20 Swan). The average variable cost for Tender Crust would be 13.27¢, applying the 80% ratio adopted for the purposes of this decision. Accordingly, the 13.05¢ wholesale price on Tender Crust 1 lb. white bread was below Continental's average variable cost. Many other wholesale prices were below Continental's fully allocated costs (Admission, Set 6 (amended) Item 9)).

86. At the outset of the Tender Crust program 50 stores had become members of Five States. There were more than 100 member stores in Five States by early 1965, and more than 150 had joined the program by February 1967. Five States had 200 member stores by January 1969. At that time Associated Grocers had 415 member stores (CXs 1515Z–22, Z–62; 7214 Johnson; *see* CX 1423B–6 Vanwyk).

87. In 1966, Continental's sales of Tender Crust products to the Five States grocers amounted to $670,000. In 1966, such sales were between $670,000 and $1,000,000 and in 1968 were over $1,000,000 (7217–18, 7291–92 Johnson; CX 1515–Z–22, 62). In the first four weeks of 1965, Continental sold an average of 60,000 loaves per week of the 1 lb. expanded size. In December 1967, when the so-called "sliding scale" was in effect, sales of 1 lb. Tender Crust averaged 90,000 loaves per week (CX 1727G Vanwyk).

88. In 1967, the total of independent wholesale bakery sales in the Denver market was still approximately $14,000,000. Continental had the largest share with 51.2%, Campbell-Taggart had 22.1%, Interstate had 20.1% and Old Homestead had 6.3% (*See Old Homestead, supra*, at 105).

89. When the Tender Crust program came to a grocery store that Old Homestead serviced, Old Homestead immediately lost shelf position, space and volume (CX 1706 Roberts; 7079 Tipton; 7327–29 Aldrich). In the Five States grocery stores, Tender Crust and Wonder bread occupied 75% of the bread rack (CXs 1706E–G Roberts; 1717C–D Chapman; 7328–29 Aldrich; 7398 Phillips). In some Five States

member stores Old Homestead lost the account completely (7616, 7618, 7620 Stevens; 7356–57 [29] Rheinfrank). The erosion of Old Homestead's market position was a continuing process that started in August 1964 (CX 1706H Roberts; 7669 Stevens).

90. Continental's weekend specials also had a very detrimental effect on Old Homestead. These specials greatly increased Old Homestead's stale percentage, which became one of the worst elements of Old Homestead's costs (6924–25 Downing).

91. Continental's plant manager thought that there was a possibility that Old Homestead would go out of business (*See* CX 1423B–71 Vanwyk; *see also* 6939–41 Downing). On December 31, 1967, Old Homestead withdrew from the baking industry (6851 Downing).

92. On December 18, 1967, Continental announced price increases to be effective January 2, 1968. One pound advertised bread was increased to 21¢, secondary label was increased to 19.5¢ and private label increased to 18¢ on a no stale return basis. All discounts were eliminated (CX 1569; RX 1150). In March 1968, prices were reduced, 1 lb. Wonder to 17¢ and 1 lb. Tender Crust to 13.05¢ (CXs 1696D; 1578).

93. Continental, Interstate and Campbell-Taggert each made a profit on their bread operations in Denver in 1967 (CX 1401F). Only Old Homestead showed a loss in that year (CX 1510C). 1967 was the first year since 1960 that Continental made a profit, *i.e.,* $14,000 (CX 1401F).

94. Continental retained the Tender Crust private label business until the middle of 1978. At that time Interstate offered a lower price and became Associated Grocer's supplier of private label bread. However, in November 1979, Tender Crust, dissatisfied with Interstate, solicited bids from the wholesale bakers and Continental again became the supplier of Tender Crust (9562–64 Nuziard).

95. From the various reports on production and market surveys it appears that in the 1970's Campbell-Taggert has become the largest wholesale bread baker in the Denver market with Continental and Interstate about equal (9543, 9554 Nuziard; *see* CXs 1385–89; RXs 1024 (*in camera*); 1031 (*in camera*); 1032A–B (*in camera*); 1044 (*in camera*); 1051A–D (*in camera*); *see also* RX 843A.). Oroweat purchased Star of Denver in 1977 (7103 Cauble). Continental's Regional Vice President testified that during the last ten years Safeway and King Soopers have a share of approximately 85% of the retail grocery business in the Denver market (9543–44, 9546 Nuziard). Recently, both of these large chains have constructed large new bakeries in Denver (9546–51 Nuziard).

96. It is found that during the period 1964 to 1968 Continental discriminated in price between purchasers of its advertised bread and purchasers of its private label bread and that during most of this

period those lower discriminatory [30] prices were below Continental's fully allocated costs. It is further found that in the last quarter of 1967, Continental's lower discriminatory prices were below its average variable costs. In most instances, these lower prices were not granted to meet the equally low price of one of Continental's competitors. It is found that Continental's pricing practices contributed substantially to the failure of Old Homestead and that as a result thereof the wholesale white bread market has become more concentrated in the Denver, Colorado, market area.

97. Complaint counsel also contend that the discriminations in price between competing Tender Crust customers which resulted from Continental's sliding scale discount program in effect in September, November and December of 1967 caused the type of injury to competition between such customers proscribed by Section 2(a) (*See* CX 2101 Stip; CC Memo. 93). The maximum price difference was 8/10th of one cent and 4% of $400 worth of purchases, *i.e.*, $16 (*See* CXs 1549; 1652Z–47, Z–50). This maximum price difference was in effect between September 16, 1967 and November 6, 1967. These discriminations were eliminated on January 2, 1968.

98. During this period Continental had many Tender Crust customers in Denver, in other cities in Colorado and in Wyoming (*See* CX 1652Z–48Z49; 1523). Although it is highly probable that some of the Five State grocers (the purchasers of Tender Crust) competed with each other, there is nothing in the record to demonstrate that Tender Crust purchasers at the different discount rates of the sliding scale actually competed with each other.

99. Given the small amount of the price difference challenged as well as the relatively short period of time that it was in effect, it cannot be found on this record that the effect of such price differences may be to substantially injure competition between retail grocers.

Minneapolis (Twin Cities Trading Area)

100. Complaint counsel challenge certain pricing practices engaged in by Continental in the so-called Twin Cities Trading Area ("TCTA") in Minnesota during the period 1966 through 1969 (*See* CSCPF 9–1–9–177; CC Mem. 96–115). This market area includes the Twin Cities of Minneapolis and St. Paul, and seven counties surrounding them (CX 306; 6075 Alton).

101. Continental's Minneapolis bakery was part of one of its "Chicago" regions which also included bakeries located in Rochester, Minnesota, Davenport and Sioux City, Iowa, Omaha, Nebraska, Milwaukee, Wisconsin, and Chicago ("Shiller Park") (CXs 220A; 307B).

102. The other major wholesale bakers selling white pan bread in

the TCTA from 1965 to 1970 were American, Zinsmaster Baking Company ("Zinsmaster"), Pan O Gold Baking Company ("Pan O [31] Gold"), Creamy Crust Baking Company ("Creamy Crust," a subsidiary of Tender Crust, Eau Claire, Wisconsin) and Emrich Baking Company ("Emrich"). Emrich sold primarily to restaurant and institutional accounts (6077 Alton; 6189 Peterson; 6338 Monahan; 6556 Coolidge; 8714 Williams).

103. In the late 1960's, Continental's Minneapolis bakery used a continuous mix process as well as a special conventional mix process, to produce mostly white bread and bun varieties (CXs 208A; 303A–B; 8761 Williams; *see* 8975–77 Brown). It ran approximately 63 bread routes from its plant or from agencies located in the Minnesota communities of St. Paul, New Hope, Willmar and Sauk Center as well as Eau Claire, Wisconsin (CX 200F–F; *see* CX 250A–p; 6319 Hueller). It also supplied Continental's Rochester bakery with some bakery products (6298 Glass; *see* CX 200B–D).

104. Continental's Rochester bakery used a conventional mix process and produced white bread, dark bread varieties and buns, rolls and doughnuts (6282 Glass; CXs 208A, 304A–B). It had agencies located in the Minnesota communities of Owatonna and Mankataz, and in La Crosse, Wisconsin (CX 200G–H). It supplied bread products to Continental's Minneapolis bakery as well as many other Continental bakeries (6298 Glass; *see* CX 200B–D).

105. The Rochester market area was considered separate from the TCTA. The areas served by Continental's Minneapolis and Rochester bakeries did not overlap and bread prices in Rochester and Minneapolis-St. Paul were unrelated to each other and fluctuated independently (6289–90, 6299–6300 Glass; 8697–98 Williams; 8820 Brown).

106. Continental's advertised bread was sold under the Wonder label while its largest selling secondary label was Wonder Country Style (CX 208B–C). The Minneapolis bakery sold private label to three large chain stores: Applebaum, Penny's and Kroger (8783 Williams).

107. American had bakeries in Minneapolis and St. Paul (6290 Glass). It was the largest wholesale baker in the TCTA and sold its advertised bread under the Taystee label (6196 Peterson; 6321 Hueller; 8684 Williams; 8813 Brown). It used the continuous mix process during the 1966–1969 period (6210 Peterson). It ran approximately 80 routes out of its plants and agencies (6138 Alton). American also sold bread under private label (RX 407B).

108. In the late 1960's, Zinsmaster had two bakeries in the TCTA, one in Minneapolis and one in St. Paul. The Minneapolis plant was operated as a Kosher plant and baked primarily white bread and Zweiback toast (6181–82 Peterson). The St. Paul plant baked buns, rolls and sweet goods (6182 Peterson). Zinsmaster was considered to

be the largest seller of advertised bread in the TCTA, which it sold under the Master label (6196 Peterson). It used a conventional mix process which apparently gave it an [32] advantage over American and Continental, both of which used the continuous mix process (6210 Peterson). Zinsmaster sold secondary bread under the Thrifty, Oven-Glo and Sky Line labels. It did not sell private label bread in the TCTA (CX 268I; 6183 Peterson).

109. In 1966, Pan O Gold, which had a bakery in St. Cloud, Minnesota, bought Regan Bakeries Inc., including a bakery in Minneapolis (6068–71 Alton). It also purchased the Twin Cities sales operation of Eddys Bakery Company (6070 Alton; *see* RX 1072Q). Thereafter it sold primary bread under the Holsum label, and secondary bread under the American Beauty, Holsum, Better Buy and Eddy's Cabin Style labels (6080–82 Alton). It also sold private label bread to chain stores including Country Club (20 stores; Country Club label) and Super Value (30 stores; Favorite label) (CX 283C–F; 6113–15, 6081–82 Alton). Pan O Gold used a conventional mix process (6210 Peterson). Most of its white bread sales were made either under private labels or secondary labels (RX 411E–G; 6150–51, 6163 Alton; 6517 Reinartz).

110. After Creamy Crust merged with Tender Krust in 1960, it discontinued baking operations, and was supplied with bakery products by Tender Krust (6381, 6389–90 Lindebck). It sold advertised bread under the Bunny Bread label and secondary bread under the Creamy Crust label (6385 Lindebak). It also supplied private label bread to the following major chain stores: Shopper's City, Johnson Brothers, Piggly Wiggly (Sunset Gold label) and Walsh's (6334–35 Monahan; 8729 Williams). Approximately 90% of Creamy Crust's sales were made under private label (6336, 6347–48 Monahan). It was the first wholesale baker to offer private label bread to the chain stores in the TCTA (6357 Monahan).

111. In 1966, the approximate market shares of the wholesaler baked white bread market in the TCTA were American, slightly over 30%; Continental, slightly under 30%; Zinsmasters, 20%; Pan O Gold, 15%; and Creamy Crust 5% (6339, 6550–52 Monahan; 6195–98 Peterson; 6117–18, 6138 Alton; 6424–25 Coolidge; *see* CX 270K). It appears that Zinsmaster and American were leaders in sales of advertised white bread with Continental in third position (6196–97, 6248–49 Peterson). Continental appears to have been the largest seller of secondary and private label white bread (*See* CX 204 J–K).

112. Two major chain stores had "captive" bakeries in the TCTA in 1966: Red Owl and National Tea (6190–91 Peterson). Holiday Discount Stores, a two store chain selling general merchandise, operated a bakery in one of them in 1966. It produced a "poor" loaf of bread by a fast and cheap process (6192 6245 Peterson; 6439 Coolidge; CX

2355B, C Coolidge). In 1966, the captive bakeries sold about 30% of the white bread in the TCTA (6120–21 Alton). In addition to these captive bakers there were many "in-store" bakeries. In 1968, Penny's opened its own bakery, in which it baked buns, rolls and sweet goods. [33] It is estimated that the captives and in store bakeries accounted for 50% of the white bread sold in the TCTA (6120–21 Alton).

113. The highest volume white bread loaf sizes sold in the TCTA were the 1 1/2 lb. round top and sandwich loaves (6115 Alton; 6190 Peterson; *see* CX 204C–L).

114. During the period 1966 to 1970, Continental was considered to be the price leader among the wholesale bakers in the TCTA, because historically it was the first wholesale baker to increase or decrease the wholesale price of bread (6339, 6362 Monahan; 6387, 6408 Lindebak; 6229 Peterson; *see* 8965 Brown). Continental was also considered to be the price leader in the Rochester market (6387 Lindebak).

115. No wholesale baker could sell bread products in the TCTA at a wholesale price higher than its wholesale baker competitor's price for a comparable product (6352–53 Monahan; 6408 Lindebak; *see* 6211 Peterson).

116. Although there was always keen competition among retail grocers in the pricing of white bread products, by the middle of 1966 the retail price spread between private label bread and advertised label bread had been reduced to about 5¢ (RX 1072D). The wholesale price for a 1 1/2 lb. loaf of advertised label bread was 28¢ and the retail price of that loaf was 35¢. The wholesale price for secondary bread was 24.5¢ and the retail price for secondary bread was 31¢. The wholesale price for private label bread with rack service was 23.5¢ and the prevailing retail price for private label bread was 29¢ (RX 1073J).

117. In November 1966, Holiday Discount Stores opened a new store in Fridley, Minnesota, a community in the Northern suburbs of the Twin Cities. Its retail price for bread baked in its own bakery was 21¢. The chain stores reduced their retail price on private label bread from 29¢ to 21¢. Penny's, to which Continental supplied private label bread, advertised its 21¢ retail price. Although Holiday raised its retail price to 23¢ on November 12, it reduced it to 21¢ shortly thereafter (CX 315; 8938–40 Brown; *see* RX 1072W, 1073J; 6246 Peterson).

118. On December 15, 1966, Continental reduced the wholesale price of its secondary label Country Style white bread from 24.5¢ to 20¢ in TCTA (CX 207C; RXs 1072V, W; 1073 J). At that time, the fully allocated costs of manufacturing and distributing Wonder Country Style from the Minneapolis plant was 23.45¢ (CXs 204Q, 249). At the 20¢ wholesale price for this secondary bread, each loaf was sold at 3.45¢ below Continental's fully allocated costs. For over two months, or until February 23, 1967, Continental's wholesale price for Wonder

Country Style white bread remained below its fully allocated costs (CXs 207C; 204Q; 249). [34]

119. Continental's Minneapolis plant stated that this price reduction was to meet the competition from Red Owl and Holiday (RX 413A; *see also* CXs 300B, 295C).

120. At the time the Wonder Country Style was being sold at wholesale at 20¢ in the TCTA, it was sold in the Rochester trading area at 24.5¢, and Continental's advertised Wonder bread was sold at 28¢ in both the TCTA and the Rochester trading area (CX 207C).

121. After Continental reduced its wholesale price for Wonder Country Style it reduced the wholesale price of private label bread to its three large chain store accounts (CX 202F; *see* CXs 207C; 209P). The record shows that the losses incurred by Continental's Minneapolis plant increased substantially after these price reductions were made (CX 308D,I,N,S).

122. On March 7, 1967, Zinsmaster introduced a 1 1/2 lb. "split top" loaf of white bread, for a "premium" wholesale price of 30¢. Continental had been successful with this product in Chicago selling it at the premium price of 31¢ (6116–17 Alton; CX 202Q). On March 24, 1967, Continental introduced its own split top loaf with a wholesale price of 23¢ (CXs 207C, 316, 318). Pan O Gold also introduced a similar split top loaf under the "Bonanza" label in March 1967 (6116 Alton; CX 283C–E). Zinsmaster stopped selling its split top loaf on May 20, 1967, because of a sales decline after Continental's split top loaf came on the market at a lower price (CX 300 D; RX 409B; 6221–62 Peterson). Continental used a mechanical device to split the bread (8705–06 Williams; 8815 Brown). The Minneapolis plant ordered production of two "loaf splitters" on December 16, 1967 (CX 310).

123. The retail price was continued into mid-1967, with Red Owl, Penny's, Johnsons and Shopper's City advertising special low prices on white bread (CX 319; RX 1073J–K). By July 1967, an 8¢ to 16¢ differential had developed between the retail price of Wonder advertised bread (as well as other advertised bread) and the retail price of private label (including captive label) bread in the TCTA (RX 406; 8687–88 Williams; 8816 Brown). This resulted in a loss in volume of advertised label sales for all wholesale bakers (8816 Brown; 8687–88 Williams; *see e.g.*, RX 405A–C).

124. On June 28, 1967, Pan O Gold's Minneapolis plant was damaged by a severe wind storm and it did not bake bread for six weeks (6097–98 Alton). During that period it supplied about 15% of the white bread sold by it in the TCTA from its Pipestone and St. Cloud plants (6099 Alton). It purchased bun products from American and Zinsmaster (6101–02 Alton), sandwich bread from Emrich and most of its white bread from Red Owl's captive bakery (6102–03 Alton).

Although Alton testified that Continental refused to supply Pan O Gold with bread products (6103), Williams, who became Continental's Minneapolis plant manager the weekend of the storm, testified that Continental never received [35] a request from Pan O Gold (8696). In any event, Continental did not supply bread products to Pan O Gold during the period its Minneapolis plant was out of production.

125. After a strategy meeting between Continental personnel from the Minneapolis plant, Chicago Regional Office and Rye Headquarters, Continental on July 24, 1967, reduced the wholesale price of its 1 1/2 lb. Wonder advertised bread (round top and sandwich) by 8¢ a loaf, from 28¢ to 20¢ in the Twin Cities metropolitan area, reduced the wholesale price of Wonder Country style from 21.5¢ to 18¢, and reduced the Wonder split top white bread from 23¢ to 20¢ (8733–37 Williams; CX 207C; *see* RX 1073P). These price reductions were met by other wholesale bakers on their advertised and secondary bread. Zinsmaster lost all sales to Penny's on July 24, 1967, because it didn't reduce its prices immediately (6222–23 Peterson; 6431–32 Coolidge).

126. Continental officials testified that they hoped that a short term price reduction would preserve its advertised bread franchise, that they expected that all wholesalers would benefit from increased sales of advertised bread, and that bread prices would eventually return to higher levels (RX 406; 8690–91, 8698 Williams; 8817–8820 Brown).

127. In July and August, 1967, in conjunction with the price reduction on Wonder bread, Continental engaged in a newspaper advertising campaign in the Twin Cities area announcing a 10¢ reduction in the retail price of advertised bread and a 4¢ reduction in the retail price of Wonder Country Style, its secondary bread (*See* CXs 222–227, 314A–D; 6106–07 Alton; 8695, 8764–67 Williams). Similar advertisements were published in the outlying Minnesota and Wisconsin communities (CX 221F–J; CX 222F–N).

128. At the time of the July 24, 1967, price drop on Wonder round top and sandwich breads, the fully allocated costs of manufacturing and distributing these products from Continental's Minneapolis bakery were 25.12¢ and 25.13¢, respectively. The price reduction to 20¢ was therefore, below Continental's fully allocated costs by more than 5¢ and, pursuant to the formula adopted for this case, was apparently below average variable costs (80% of 25.12¢ equals 20.1¢) (*See* CX 204Q; 249; Finding 45, *supra*). The so-called July 24, 1967, prices were in effect for approximately a month and a half, or until September 11, 1967, when the wholesale price of advertised label bread was increased to 23¢. Thereafter, for a period of ten months the prevailing wholesale price in the TCTA for Wonder round top and sandwich white bread was over 2¢ per loaf below Continental's fully allocated costs (CXs 207C, 204Q, 249; *see* 8798 Williams).

129. At all times from July 24, 1967, until July 21, 1969, the Wonder round top and sandwich white bread were sold at wholesale in the Rochester trading area for 28¢ and Country Style was sold at wholesale for 24.5¢ in the Rochester area (CX 207C). [36]

130. The retail price war continued and on October 5, 1967, Continental reduced its wholesale price on 1 1/2 lb. private label round top and sandwich bread to its three chain store accounts by 4¢ (CXs 202F, 209P, 245C, D, 309A–D). The prevailing wholesale price to Applebaums on rack service and stale return was reduced from 19.5¢ to 15.5¢ (CX 309A). The actual wholesale price, including a 2% central billing discount, was 15.15¢ (*See* CX 318).

131. At the time of the October 5, 1967 price reduction the fully allocated cost of manufacturing and distributing Pantry Pride round top and sandwich bread to Applebaum from Continental's Minneapolis bakery was 19.81¢ and 19.56¢, respectively (CXs 204R, 249). The wholesale price of 15.19¢ was below Continental's fully allocated costs and, pursuant to the formula adopted for this case, was apparently below Continental's average variable costs (80% of 19.56¢ equals 15.6¢). The October 5, 1967 prices remained in effect for approximately two months, until November 9, 1967 (CXs 207C, 204R, 249).

132. Between the weeks of October 7, 1967 and November 11, 1967, Continental's Minneapolis bakery sustained a net loss in profits before taxes of $45,336.85 (CX 250 K-P).

133. On March 14, 1968, Pan O Gold announced a 3¢ per loaf increase on advertised and secondary bread and an increase of 2.5¢ on private label to become effective March 25 (6506, 6518 Reinartz; 6115 Alton; CX 283C-E). On March 20, 1968, Continental announced an increase of 1.5¢ on secondary and private label to become effective on April 1, (6506–07, 6518 Reinartz; 8701 Williams; CXs 229A, 230B, 232B, 233B, 234B, 235I, 245H; RX 416; *see* RX 1074C). The other wholesale bakers followed Continental's price increase, and Pan O Gold met Continental's price. Zinsmaster did not consider Pan O Gold to be a significant factor in the advertised bread market (6230 Peterson).

134. On April 2, 1968, Zinsmaster instituted a treble damage suit against Continental for its pricing practices in the TCTA (CX 299F; 6436–37 Coolidge).

135. On July 3, 1968, Continental announced an 1.5¢ price increase on primary, secondary, and private label bread, effective July 15, 1968 (CX 207C).

136. On December 2, 1968, Pan O Gold announced a wholesale price increase of 3.5¢ on advertised and 3¢ on secondary to become effective on December 23, 1968 (6507–09 Reinartz). Continental did not follow this price move, but announced, before December 23, that it would

increase its wholesale prices by 1.5¢ and 2¢, on advertised and secondary labels respectively (6509 Reinartz). The other wholesalers, including Pan O Gold, increased their prices to match Continental's prices (6509, 6514 Reinartz). **[37]**

137. On July 21, 1969, Continental raised the wholesale prices of Wonder advertised bread again and the wholesale prices of the 1 1/2 lb. loaf of Wonder round top and sandwich and the split top loaf were 28¢ a loaf (CX 207C). These were the prices prevailing in the Rochester area (CXs 202H, 207C).

138. During the period of "low" prices on advertised bread, the profits of all the major wholesale bakers including Continental were substantially decreased (CXs 248, 250; RXs 1073P, 1074D, I, 6112, 6142–45 Alton; 6509 Reinartz; 8775–76 Williams). Zinsmaster lost profits during this period and was forced to curtail its advertising (6226 Peterson; RX 1074D). Pan O Gold lost sales and estimated a loss of profits of $1,600,000 (6112, 6142 Alton; 6509 Reinartz). It discontinued all advertising and capital expenditures except those for emergency repairs (6113 Alton). In 1970, it went through a "Chapter 11" bankruptcy proceeding (6145 Alton). Creamy Crust suffered a net loss for bread sales in the TCTA each year during the period; its loss rising from $13,748 in fiscal year 1967 to $70,391 in fiscal year 1968. In 1969, Creamy Crust lost $11,767 (6386 Lindebak; CX 294F; RX 410D).

139. The treble damage suit instituted by Zinsmaster and joined in by Tender Krust/Creamy Crust in July 1968 and Pan O Gold in 1969, was settled and certain agreed-upon damages were paid to the plaintiffs by Continental. Pan O Gold received $200,000 (6145 Alton). In addition, the Court entered an order on January 11, 1971, prohibiting the parties from selling bread products at different prices in an extensive area of southern Minnesota, an injunction that was to be in effect for four years (CX 299).

140. Although Continental reported in 1971 that it had surpassed American as the number one seller of white bread, it appears that American is the largest producer of white bread in the TCTA today (*See* CX 4(131); 10227–28, 10242 Metz). In 1978, Metz Baking Company purchased Zinsmaster and in early 1980 was in the process of constructing a new bakery in Minneapolis (10202, 10242 Metz). Metz and Continental are about equal sellers of bread products, following American. Heileman Brewery has purchased Pan O Gold and Emrich (10227 Metz). Pan O Gold's old Minneapolis bakery has been closed and sales to the TCTA are made from the St. Cloud plant (8794 Williams; 10262 Metz). Creamy Crust is no longer in Minneapolis (8793 Williams). The captive bakeries continue to maintain very strong positions in the market (RX 1078D; 8716 Williams; 10209–10, 10222–23 10227 Metz).

141. Minneapolis is still a private label bread market. Variety breads have taken over much of the bread market and sales of white bread have declined. Continental now concentrates its efforts on its sales of advertised bread (8707–13 Williams). [38]

142. On December 10, 1968, the Commission's Bureau of Restraint of Trade (now Bureau of Competition) advised Continental that the Commission had received a complaint concerning the pricing of Continental's products in the Twin Cities trading area alleging violation of Section 2(a) of the Clayton Act (RX 404A). After Continental had submitted certain information, the matter was closed by the Commission on October 27, 1970, without prejudice to the right of the Commission to reopen the matter if and when warranted by the facts (RX 403G; *see* RXs 402–404).

143. As to the TCTA, it is found that Continental discriminated in price among its customers and that the effect of such discrimination may have substantially injured competition between Continental and its wholesale competitors. It is also found that the lower prices to certain customers were below Continental's fully allocated costs and, in several instances, were below its average variable costs. It is also found that Continental's lower discriminatory prices were not made to meet the equally low price of a competitor, but were made with the express intention of restructuring the wholesale bread market in the TCTA. In this respect, it is found that Continental maintained its lower discriminatory prices over long periods of time when it knew or had reason to believe that its wholesale competitors were suffering large economic losses and, perhaps, were being irreparably injured in their ability to compete in the sale of advertised label bread, secondary bread, and private label bread in the TCTA. Finally, it is found that the wholesale baking segment of the white bread market in the TCTA has become more highly concentrated over the years.

Seattle Marketing Area

144. Complaint counsel challenge certain actions taken by Continental in the Seattle marketing area during the 1960's and early 1970's. Unlike the other five marketing areas studied in Docket 9000, the Seattle phase of the case does not contain allegations of illegal price discriminations. (CCPF 10–1–10–44; CC Mem. 116–119; CC Reply Br. 76–78).

145. Continental's Seattle bakery is part of the Northern California Region (Redwood City) which also included bakeries located in Portland, Oregon, Spokane, Honolulu, San Francisco, Sacramento and Oakland (3163 Frielink).

146. The Seattle marketing area includes generally the metropolitan areas of Seattle and Tacoma (*See* CX 1191).

147. Other wholesalers in the Seattle area during the last half of the 1960's included American, Gai's Baking Co. ("Gai's"), Hansen, and Oroweat (6621 Vail). Another baker, Ruth Ashbrook ("Ashbrook") produced bread for Associated Grocers, a voluntary cooperative association, and distributed bread products to members of the cooperative. Gai's was primarily a [39] variety bread baker until it built a new plant in the late 1970's and began producing large volumes of white bread (9327 Frielink).

148. During the mid 1960's, Safeway was the only captive baker in the Seattle area. Later Fred Meyer sold captive label bread in Seattle, bread that was baked in its Portland, Oregon bakery (6683 Vail; 9303–04, 9328 Frielink).

149. At all times relevant herein, Continental was shipping bread baked in the Seattle bakery to Alaska (6581–83 Stip.).

150. It appears that Continental's share of the wholesale white bread market in the Seattle area was approximately 25% in the early 1970's (*See* CCPF 10–6; CX 135).

151. The most popular sized loaf of white pan bread sold in the Seattle area during the late 60's and early 1970's was a 22.5 oz. loaf (4368–69, 4377 Salle; 6622–23 Vail).

152. In 1963, George T. Vail and Boyd Hall, who had been selling bread house-to-house, began selling bread at wholesale in the Seattle area (6612 Vail). At first they purchased bread from Ruth Ashbrook, but this source of supply was terminated after a short while, due to certain pressures by Local 227 of the Teamsters Union (*See* 6615, 6672–73 Vail). Thereafter, and until 1972, Vail purchased bread from the Mother Hubbard Bakery in Abbotsford, Canada (6616–17 Vail; *see* 4379 Salle). Vail and Sandland, who replaced Hall as Vail's partner, formed the Granddad Bread Company, and the so-called Canadian bread was sold by them in the Seattle market under the Granddad label (6612, 6616–19, 6626, 6628–29, 6643 Vail; 6780 Sandland).

153. Vail and Sandland drove to Canada, picked up the Granddad bread products (white bread and whole wheat bread), trucked such products to the Seattle area and sold and delivered them at wholesale prices to grocers on a store drop delivery basis (*See* 6673–74 Vail; 6815 Sandland). Granddad packaged its bread in fold-up, reusable cartons that held 16 loaves. Granddad bread could be merchandised directly from these cartons (6625 Vail; CX 1188 (52) Eastey).

154. Granddad's method of transport and delivery, as well as a favorable exchange rate on the Canadian dollar during the 1960's, permitted Granddad to sell its bread at significantly lower prices than the wholesale prices charged by the wholesale bakers in Seattle (6673–74, 6696–97 Vail; 6815 Sandland). Granddad bought the bread from Mother Hubbard at 15¢ per loaf (6618 Vail). It cost Granddad about

2¢ a loaf to transport the bread from Canada (6673 Vail). In 1964-1965, Granddad charged its grocery customers 18¢ per loaf (6621, 6632 Vail; *see, e.g.*, CX 1194). Those customers usually sold Granddad bread at retail for 5 loaves for $1.00 or less (6631-32 Vail; 6754 Hinshaw). [40]

155. In 1964-1965, the wholesale price of the wholesale bakers' advertised labels was 28¢, based on a conventional 20% discount from the prevailing retail price of 35¢ (6632 Vail; CX 1197 (5) Thompson).

156. The fact that Granddad was nonunion caused it considerable difficulty throughout its existence with Local 227 of the Teamsters Union in Seattle which represented the driver-salesmen of all the wholesale bakers (6676, 6684-85 Vail; 6792-94 Sandland).

157. Early in Granddad's existence, Vail and Sandland made arrangements whereby they would purchase Hostess Cake products from Continental for Mother Hubbard and "back haul" those products to Abbotsford (6648 Vail; 6819 Sandland). Granddad was the only firm with an ICC permit to haul goods between Seattle and Abbotsford (6649 Vail; 6818 Sandland). Alternative modes of shipping involved a transfer at Vancouver. The delay incurred by such transfer adversely affected the freshness of the cake products as finally delivered to the Mother Hubbard bakery (CX 1196(165) Taylor; 1197 (204-05) Thompson; 6738 Vail). After Thompson, the plant manager of the Seattle bakery, questioned the financial arrangement whereby Vail and Sandland paid for the cake products, Mother Hubbard began paying Continental directly for those products (CX 1197 (197-98, 205) Thompson).

158. Granddad bread was equal in quality to that of other wholesale bakers (6629 Vail; *see* 6754 Hinshaw; CX 1188 (57-58) Eastey). Granddad's business "started booming right away" after it started getting bread from Canada (6626 Vail). In 1964 and the early part of 1965, Granddad sold about 40,000 loaves a week in the Seattle area (6626-30 Vail).

159. In early 1965, Continental introduced a 22.5 oz. secondary loaf of white bread called Wonder Country Style "to meet the competition of Canadian Bread, Pink Elephant and other baking companies" (CX 1022B; 6627 Vail). Pink Elephant was a home delivery baker (6612 Vail). This secondary loaf was priced to sell at retail for 4 loaves for $1 (6635 Vail). At that time neither American nor Hansen were selling secondary label bread (6713-14 Vail).

160. As a result, Granddad lost substantial sales volume in the stores that retailed both Wonder Country Style and Granddad (*See* 6633-35 Vail). During this period, Continental employees offered one grocer, Hinshaw a better price on Wonder secondary label if he would give Continental an "exclusive" and "exclude" Granddad's from the

store (6756–57 Hinshaw). Hinshaw rejected both offers (6758 Hinshaw).

161. Continental also ceased doing business with several grocers who refused to stop carrying Granddad bread (CX 1195 (8–9, 14, 15) Lundstrom; 4370–81 Salle). [41]

162. Despite the competition from Continental's secondary label and private label bread which appeared in Seattle in 1966, Granddad increased its sales to single-owned non-chain grocery stores and by the middle of 1968 was selling to 70% of those stores in the greater Seattle area (6781–83 Sandland) at which time it reached one of its two volume peaks (6782 Sandland).

163. In early 1968, Granddad's wholesale price was 22¢ a loaf and Granddad's bread was being retailed at 4 loaves for $1.00, a price that was below the retail prices of other wholesale bakers' products (6641 Vail). A general price drop on private label and secondary label bread in late 1968, which lasted for five months, "almost wiped [Granddad] out of business" (6642–44 Vail). The price of advertised bread was not reduced during this period (6644 Vail).

164. Sometime between February 27, 1969, and March 4, 1969, the wholesale price of Continental's, Hansen's and American private label and secondary label bread increased (CXs 1003; 1005; 1006; 1192 Stip.; 1197 (175–176) Thompson). Granddad raised its wholesale price back to 22¢ and started to make money again and increased its volume of sales (6646 Vail).

165. During the last quarter of 1968, Continental's Seattle bakery incurred a monetary loss on its bread production and sales (RX 703B).

166. In the spring of 1969, Thompson, Continental's Seattle bakery plant manager from 1966 until 1977, met with Taylor, the plant manager of Mother Hubbard (CX 1197 (125, 129) Thompson). Thompson told Granddad's supplier that "the Granddad price was not in keeping with the standard market price of what bread seemed to be" (CX 1196 (166–173) Taylor). Shortly thereafter, Vail and Sandland met with Thompson in the latter's office at the Continental bakery (6784–85 Sandland). Granddad's officials testified that Thompson asked them what the backhaul business meant to Granddad, advised them that bread prices were going to be increased again shortly and that Granddad should go along with the price increase so that everyone could make money. They further testified that Thompson told them that if Granddad did not raise its prices, Continental would reduce prices to five cents a loaf like it had done in other parts of the country (6648–49 Vail; 6785–86 Sandland). They testified that Thompson also told them that Granddad should not seek any more business (6649 Vail; 6786 Sandland). Thompson denied making such state-

ments, but admitted that he had discussed the backhaul business with Vail and Sandland (CX 1197 (200–02) Thompson).

167. Granddad did not raise its prices and did not stop seeking new business. Shortly after the meeting in Thompson's office, Granddad got the K-Mart account which added 13,000 loaves per week to Granddad's volume. About a week later, Granddad got the Food King account which added 8000 loaves a week (6650–51 Vail; *see* 6786 Sandland), at which time it reached its second volume peak (6782 Sandland). [42]

168. Also sometime after the meeting in Thompson's office, Continental discontinued the backhaul business with Granddad but reinstated it within six weeks because Mother Hubbard complained about the poor service it was getting from the transport through Vancouver (CXs 1196 (165) Taylor; 1197 (204–05) Thompson; 6652, 6719 Vail; 1197).

169. Also about that time, Thompson had a survey prepared to determine how much Granddad bread was being sold and where it was being sold. Thompson recognized that Granddad was a "factor in the market" and "could cause some problems" (CX 1197 (180–84) Thompson).

170. Granddad had displaced a secondary label of Hansen when it acquired the K-Mart account. Joe Collins, secretary of Local 227 of the Teamsters Union, pressured K-Mart to discontinue carrying Granddad bread (67947 Sandland; 6706–07 Vail). Granddad also lost Johnny's IGA when the Union threatened to picket that store for carrying Granddad bread (6705–07 Vail; *see* RX 700).

171. Granddad ceased buying bread products from Mother Hubbard in 1972, when it purchased the Pink Elephant bakery (*See* 4379 Stolle). The favorable exchange rate between the United States and Canadian dollar had disappeared and Vail and Sandland thought they could produce bread more cheaply themselves. They withdrew from the market shortly thereafter. In 1972, Hansen closed its Seattle bakery and consolidated its baking operations in its Portland plant (RX 707D).

172. Although Continental's sales of white bread in units increased during the period 1970 to 1973, since then the volume has returned to the 1970 level (RXs 1025, *in camera*, 1031 *in camera*). Ashbrook is the leading seller of white bread products and Gai's is the leading bread baker in the Seattle area. Continental is second to Ashbrook in white bread sales (9302–05 Frielink). Complaint counsel estimate that Continental has over 30% share of the wholesale white bread market in Seattle (*See* CCPF 10–44).

173. It is found that none of Continental's actions in Seattle, as demonstrated on this record, are sufficient to support a conclusion

that Continental, as a single firm, engaged in conduct that could be construed as an attempt to monopolize or as an unfair method of competition in violation of Section 5 of the Federal Trade Commission Act. Although it could be inferred that Continental's secondary label prices during the 1968 price war were below its fully allocated costs, there is nothing in the record to show that it initiated these low prices. Complaint counsel do not allege any illegal price discriminations. In my opinion, the introduction of secondary label bread into a market is not illegal. Merely competing with Granddad is not an illegal attempt to monopolize. All of the other events relied on by complaint counsel involve efforts of salesmen to sell their products. The withdrawal of **[43]** Continental's business from certain stores did not injure either the grocers or Granddad. It would appear that the volume of business in Continental products involved in those stores was minimal and Continental's claim that it was not economical to continue to service these accounts was probably reasonable under the circumstances. Moreover, it appears that Granddad's principal adversaries in Seattle were Local 227 of the Teamster Union, Hansen, and the driver salesmen of all the wholesale bakers.

Los Angeles-Ventura Marketing Area

174. Complaint counsel challenge certain pricing practices engaged in by respondents in Southern California generally, and in the Los Angeles and Ventura areas in particular, during the period 1966 through 1974 (CCPF 11-36-11-138; CC Mem. 120-128; CC Reply Br. 79-92).

175. Continental's Beverly Hills and DiCarlo (San Pedro, California) bakeries were part of its Southern California or Los Angeles Region (Santa Monica) which also included bakery plants located in San Diego, Denver, Colorado, Ogden and Salt Lake City, Utah, as well as the Hostess Cake Kitchen, a cake bakery, also located in Los Angeles (CXs 518; 519; 4550 A. Gordon; 4677-78, 4693-94, 4751 J. Walsh). Continental considered Los Angeles and Ventura as part of the same market, served by the same major competitors (4747, 4805-06 J. Walsh).

176. The Beverly Hills plant had both conventional mix and continuous mix process lines whereas DiCarlo Bakery was a conventional mix plant. The San Diego Bakery, originally a continuous mix plant, was converted to conventional mix in the 1970's (4691-92, 4723-24 J. Walsh). These bakeries supplied each other with bakery products (4688-92 J. Walsh).

177. Continental sold bread products produced by its Beverly Hills and DiCarlo bakeries to customers located in Arizona (9617 Nuziard).

These products were sold and delivered through its San Diego bakery (3182–83 Frielink; 4697 J. Walsh; 4759 Stip.).

178. The Beverly Hills bakery had over 200 bread routes originating from its plant or from depots in its marketing territory. The DiCarlo Baking Company served its smaller marketing territory with approximately 80 routes (*See* CX 518; *see also* RX 290; 4828–29 J. Walsh). Although these two bakeries called on some of the same grocery customers, they did not generally sell products wrapped in the same labels to the same customer (4697, 4749, 4844 J. Walsh). The two plants did not generally serve the same institution, school or restaurant accounts (4697–98 J. Walsh).

179. During the period 1966 through 1974, Continental's labels at its Beverly Hills Plant were Wonder Bread, Wonder Country Style, Holsum, Profile, Home Pride White and Wheat and Wonder Wheat. The labels used by the DiCarlo plant were [44] DiCarlos Bread, O Settlers, DiCarlo Parisian French, DiCarlo Sour Dough French, DiCarlo Taix bread, and until 1974, Big D and Mr. Big (4683–84 J. Walsh).

180. The other major wholesale bakers of white pan bread and rolls distributing products to grocery stores and restaurants in the market area serviced by Continental's Beverly Hills and DiCarlo bakeries in the late 1960's and early 1970's were Interstate, American, Prosser Baking Company ("Prosser") and Gordon Baking Company ("Gordon") (4522–23 A. Gordon; *see* 9598–99 Nuziard).

181. By the 1970's Interstate had five or six bakeries in Southern California, two of which produced white pan bread (4527 A. Gordon; 10959 Vander Geissen). Interstate closed its Long Beach, California bakery in 1974 and its Santa Barbara bakery in 1964 or 1965 (RX 1051A-C *in camera*). Interstate sold its bread under the Weber, Blue Seal, Millbrook and Log Cabin labels (4706, 4782 J. Walsh; 10959 Vander Giessen). Roman Meal, Hollywood and Jack LaLanne breads were also baked by Interstate (4769 J. Walsh).

182. American Baking Company, which had acquired Langendorf Bakery around 1964, had four bakeries in the Los Angeles area, two of which were located in Los Angeles, with the others located in San Bernadino and Pasadena, California (8852–55 Murray). American served both the Los Angeles and Ventura markets as well as San Diego and Bakersfield (4527 A. Gordon; 8855 Murray). By 1974, American had closed three of its four plants and, in December 1974, American terminated its grocery routes and withdrew from the grocery white pan bread business, redirecting the sales efforts of its Los Angeles Bell Gardens plant to the restaurant trade, concentrating on fast food establishments (RX 377; 8867–68 Murray; 4996 G. Gordon; 4897–98 Mitchell; 4713–14 J. Walsh; *see* 9608 Nuziard).

183. Gordon was founded in 1906 as a family business. Although the business was sold to Interstate in 1930, the Gordon family continued to operate the bakery for Interstate until 1936 when Gordon repurchased it. The bakery, modernized in 1963, used the conventional mix process (4510–15 A. Gordon; 4924 G. Gordon). In 1966, the Gordon Bakery was running two shifts with some overtime (4519 A. Gordon).

184. The Gordon plant, located in the center of Los Angeles, distributed its products in the greater Los Angeles area including Santa Monica, South Laguna, San Bernadino and San Fernando, California (CX 516; CX 519; 4511–12, 4583, 4661 A. Gordon; 4919, 4950–51 G. Gordon; *see* 4661 A. Gordon).

185. Gordon's primary product, the 1 lb. expanded loaf, was distributed under the Gordon label as well as several private labels (4520, 4522–23 A. Gordon; *see* 4517 A. Gordon). It also sold bread to grocery stores under the Springfield label through Certified Grocers, a grocery-owned cooperative (RX 207A-B; 4607–[**45**]09, 4521 A. Gordon). In the mid 1960's, Gordon's had a market share of 3%–5% (4917 G. Gordon).

186. Prosser was established in early 1939 (4983 Prosser). Its plant was located in Ventura, California, a coastal community located approximately 65 miles northwest of Los Angeles (CX 517; 4984 Prosser). Prosser distributed its products in the coastal area from Paso Robles south to Burbank and eastward to the San Fernando Valley (CX 517; 4987–89 Prosser). It sold bread products under the Banquet Bread, and Family Bread labels (4993–94, 5006–07, 5111–12 Prosser). During the period in which Gordon made Springfield bread for Certified Grocers, Prosser made and distributed that label in the Ventura area (RX 207A-B; 4619 A. Gordon; 5044–45 Prosser). Prosser's plant, which used the continuous mix process had been expanded and modernized in 1964, and, in 1966, was operating two full shifts plus overtime (4985, 5002 Prosser).

187. Some other wholesale bakers included Eagle Baking Company which sold exclusively to restaurants and went out of business on February 27, 1971 (CXs 481, 483; 4523–24 A. Gordon; 4707, 4715, 4771–72 J. Walsh), Modern Baking Company, which produced variety breads and sold some white sandwhich bread to grocery stores (4524 A. Gordon; 4711 J. Walsh), and Oroweat Bakeries, primarily a variety bread baker which sold some white pan bread to grocery stores (CX 460N; 4533 A. Gordon; 4783 J. Walsh). Several San Diego bakers sold white pan bread in sections of the Los Angeles market (4710 J. Walsh). Golden Creme, a cooperative bakery owned by several grocers, sold bread to members of the cooperative and other grocers. It was purchased by Food Fair in 1971 and became Food Fair's captive bakery (4523 A. Gordon; 4747, 4772 J. Walsh).

188. Interstate was the largest producer of white pan bread in the Los Angeles area during the period 1966 through 1974, with the Weber label as the largest selling brand (RX 228A-B; 4646 A. Gordon; 4782 J. Walsh; *see* 8887 Murray; 9567, 9607–08 Nuziard). Continental and Interstate's shares of wholesale bread business with grocery stores were approximately the same by 1974 (9607–08 Nuziard).

189. In 1966, the captive bakeries in the Los Angeles area were Safeway, Ralph's and Vons. Lucky opened its captive bakery in 1967 (4585 A. Gordon; 4772–74 J. Walsh). By 1974 other major grocery supermarket chains were operating their own captive bakeries. Food Fair had purchased Golden Creme. Alpha Beta, which had discontinued its captive bakery in 1961 in favor of private label bread, resumed baking its own bread in early 1972. Albertson's started baking its own bread in 1973 or 1974 (RXs 239A; 246B; 367A; 4523, 4526, 4532, 4539 A. Gordon; 4747, 4772–73 J. Walsh; 9568 Nuziard).

190. Particularly after 1966, most supermarket chains which did not have captive bakeries purchased private label bread from wholesale bakers (4523, 4534, 4539 A. Gordon; 4772–73 **[46]** J. Walsh; *e.g.*, CXs 409; 412; 416–421; 429–430; 442–445; 447–452).

191. The most important loaf size in the Southern California area was the 1 lb. expanded loaf of white bread (8854 Murray; 4734 J. Walsh; 4995 Prosser).

192. Continental considered that it was generally the leader of price increases in Southern California on advertised label and private label bread. (CX 490B).

193. Before 1966, the major grocery chains did not have many outlets in the Ventura area (4997–99 Prosser; *see also*, 5002, 5069–71 Prosser). Prosser had a 40% share of the Ventura market in 1960 while its competitors, operating from depots in the Ventura area, had lesser shares: Interstate 30%; Continental 20%; and American 10% (4989, 4993, 5004 Prosser).

194. Jordano's, Williams Brothers, Scolari's, Santa Cruz, B&D, McDaniel's and Bayles were Prosser's most important grocery store customers in 1966 (5007 Prosser). Prosser did not sell private label bread to grocery stores and 70% of its sales were of its primary label bread, Prosser Banquet (5007 Prosser). Grocery store customers accounted for approximately 50%–60% of Prosser's sales (5099–5100 Prosser; *see also*, CX 505A-I; 5055–58 Prosser).

195. As the major grocery chains expanded into the coastal area, the major wholesale bakers, including Continental, began granting discounts to the other grocery stores, discounts which Prosser met (RX 363F-H; 5009 Prosser; *see* 5131–32 Thompson; 5160 Hauser; *see also*, 5040 Prosser).

196. In 1966, Prosser still had 40% of the market and Continental

had increased its share to 30%, whereas Interstate share had declined to 20% and American share remained at 10% (5008 Prosser).

197. During 1966, Prosser developed, proposed, and successfully negotiated a private label program for the approximately fifty Food Fair Grocery Stores in the Los Angeles area, some of which he had been supplying with Prosser Banquet label bread. Prosser began distributing private label bread to Food Fair's eleven stores in the Ventura, Santa Barbara and San Fernando area. He leased a warehouse in central Los Angeles from which he planned to distribute private label bread to the rest of the Food Fair stores in the Los Angeles area (CX 519; 5010–12 Prosser; 5136–38, 5141 Ashton).

198. Plans to establish a Los Angeles depot, as were the plans to serve Food Fair stores in Los Angeles, were abandoned by Prosser after discussions with representatives of Interstate and Continental (5014 Prosser; 5137–40 Ashton). Prosser did continue to serve some Food Fair stores in the San Fernando Valley while Continental, and later, Interstate, supplied [47] private label bread to Food Fair's Los Angeles stores until it purchased the Golden Creme Bakery (CX 444A-J; RX 354M; 4747 J. Walsh; 5014 Prosser; 5139–40 Ashton).

199. In late 1966 Continental, Interstate and American reduced their wholesale prices of 1 lb. expanded advertised label bread by 6¢ (5019–24 Prosser). At the same time, these wholesale bakers reduced their prices on eight-pack hot dog and hamburger buns (5026 Prosser). Prices did not increase until March 19, 1971 (5025 Prosser).

200. Beginning in 1966 and continuing at least through 1968, Continental engaged in widespread sampling of Prosser's restaurant accounts (5026, 5028–29 Prosser; 5122–23 Thompson; *see* CX 424A-B, D, K, Z-6, Z-9, Z-16-18; *see also* CX 2361A-I; RX 378B, D, F; 5028–29, 5077–78 Prosser).

201. In 1967 Continental introduced its secondary bread under the Holsum label in the Ventura area (5031 Prosser *but see* 5101–03 Prosser (1964 or 1965)). The secondary label 1 lb. expanded white bread, which later was replaced by private label bread, was sold at a retail price of 5 loaves for $1.00. In 1966, Prosser's fully allocated cost of baking and distributing 1 lb. expanded bread was 20¢–21¢ (5006 Prosser). Prosser lost much shelf space in its principal accounts to Continental's Holsum label (5035–42 Prosser).

202. As a result of these pricing moves by Continental and the other wholesaler bakers Prosser lost many restaurant and grocery store customers. Prosser's sales were reduced to some of its principal grocery accounts, Prosser was required to grant discounts to hold business, and Prosser sold bread products at net prices below its costs (5027–44, 5050–51, 5079, 5099–5100 Prosser; 5123–24 K. Thompson; 5149–50 Hauser).

203. In November 1969, after Gordon replaced Continental as the supplier of Certified Grocers' Springfield private label bread, Gordon entered into an arrangement whereby Prosser would bake and distribute Springfield Bread to grocery stores in Prosser's marketing area (RX 207; 5044 Prosser). Prosser, however, did not get the Springfield private label business in many of the grocery stores Continental had previously supplied with Springfield bread. The stores substituted Continental's secondary label, Holsum for Springfield, apparently at a better price (5045–46 Prosser).

204. In June of 1970, Continental Beverly Hill bakery advised its Regional Office that future sales opportunities might open up because "[C]ontinued selling pressure may force withdrawal of some wholesale competition from the market. Weak bakers in the market are American, Prosser and Eagle" (CX 410B). "[E]liminating competition" was included in the report "[A]mong the methods for obtaining sales" (CX 410J). [48]

205. In 1970 and 1971 Prosser lost more grocery and restaurant customers when he could not meet or hold prices at Continental's levels since they were below Prosser's cost. In 1971 Prosser's fully allocated cost for 1 lb. expanded bread was 22¢ compared to 20–21¢ in 1966 (5006, 5051–53 Prosser; *e.g.*, RX 280A-U; CX 441N, Z–9, Z–22, Z–26, Z–188, Z–189, Z–228–339; 4799–4803 J. Walsh). In 1970 Continental's price of around 18¢ for private label 1 lb. expanded bread was 4¢ below Prosser's fully allocated costs (5042 Prosser). In 1971 Prosser tried to meet Continental and Interstate prices by selling private label bread to Williams Brothers and Jordano's. Prosser lost those accounts when he tried to raise the 18.5¢ price to cover his fully allocated costs of 22¢ (5051–53 Prosser).

206. In 1970 Continental was ranked first in the sale of the dominant 1 lb. expanded loaf in the Ventura area (5146 Ashton). In 1971 Continental's share of the Ventura market was 40%, Interstate ranked second at 30%, Prosser had 20%, and American 10% (5062 Prosser; 5146–47 Ashton).

207. By 1971 Prosser's weekly route average had fallen to approximately $1000 from $1400 in 1966 and the number of routes had declined to 23 from 39 in 1966 (5002, 5038 Prosser). Prosser's bakery was profitable until 1967 and ran at a loss until it closed, with the exception of 1969 in which the company showed a marginal profit (CX 505A-I; 5057–58 Prosser).

208. Prosser discontinued its wholesale routes on November 20, 1971, and after baking Pepperidge Farm Bread for a time, Prosser ceased all operations on February 20, 1973 (4983, 5054, 5059–60, 5063 Prosser; *see* CX 505A).

209. Continental made plans to fill the vacuum left by Prosser's

imminent exit by expanding its routes and coverage in the Ventura area. One driver testified that he was offered positions with Continental even before it became evident that Prosser would soon close (CX 480C; *see*CX 480F; CX 470D; 5125–27 Thompson; *see generally*CX 483; RX 365A-B).

210. Sometime after Prosser went out of business, Continental discontinued sales of Holsum in the Ventura area (9614 Nuziard; *see also* 9676 Nuziard).

211. Continental has established itself very firmly in the Ventura market since Prosser withdrew. Continental now has the greatest share of that market (10945–46 Vander Giessen).

212. The introduction of secondary and private label bread in the Los Angeles area by the major wholesale bread bakers also had an adverse effect on Gordon's sales (4549 A. Gordon). In 1966 or 1967 Gordon's lost the Market Basket account, which comprised approximately 20% of the bakery's volume, to American which offered private label at a price below Gordon's cost. Gordon then sought a private label program at Boy's Markets and redirected his sales efforts to fast food restaurants (4556–57 A. Gordon). [49]

213. Until the loss of the Market Basket account, Gordon had not sought other private label business, since it felt such business was not profitable. The Boys account, marginally profitable to Gordon's when first obtained, did not continue to be profitable because Gordon was forced to lower net wholesale prices below its costs to meet periodic offers from Continental (4563–65, 4570–71 A. Gordon; 4894–96 Mitchell). Gordon started the private label account with Boys because it needed the volume (4563–65 A. Gordon). Gordon's sales to Boys amounted to approximately 35,000 to 40,000 units per week and totalled yearly sales of approximately $900,000 (4562 A. Gordon; 4891 Mitchell).

214. Gordon's obtained the account at Jack-In-The-Box, a rapidly expanding fast food chain (4558–59 A. Gordon). Continental eventually acquired the account which it served at prices below Continental's costs (CXs 465; 466; CX 491A). In January 1974, Continental lost over $82,000 from its sales to Jack-In-The-Box and over $4000 from sales to Denny's (a similar fast food operation)(*Id.*). In March and October 1974, Continental still reported losses on the Jack-In-The-Box account (CXs 491D, E; 465; 466).

215. When Gordon took over the Certified Grocers Springfield Bread account from Continental in 1969, Continental offered the grocers it had been selling Springfield bread, reduced prices on secondary label bread. As a result, only 50% of the grocers continued with the Springfield program (4555 A. Gordon).

216. After Continental began to lose the Alpha Beta private label

business in 1971, it actively pursued private label business (*See* 4547 A. Gordon; CXs 53A; *e.g.*, CXs 409; 412; 416–421; 429–430; 442–445; 447–452).

217. Continental discriminated in price between Wonder products and private label bread (CX 400). For example, Continental's wholesale price on the 1 lb. expanded Wonder advertised label loaf was 23.4¢ during the period from June 1970 to June 1972 (CX 400) whereas the wholesale prices on the same sized private label products were 20¢ to Alpha Beta and 21.7¢ to Albertsons. In May 1973, the wholesale price on 1 lb. expanded Wonder was 26.4¢, and the private label wholesale prices were 23¢ to Stop N Go and 19.5¢ to both Market Basket and Heritage House (CX 400Z–30; Z–47).

218. As a result of Continental's efforts to obtain a larger share of the secondary and private label market, Gordon's lost much shelf space for its primary line bread, since Gordon's was no longer able to control the bread table (4515–16, 4537–38, 4560–61, 4597 A. Gordon; *see* 4719–20 J. Walsh).

219. Respondents' "Profit by Variety" study for its Beverly Hills bakery shows that almost all of Continental's private label white bread, including the 1 lb. expanded loaves, were [50] sold at wholesale prices below Continental's fully allocated costs (*See* CX 441).

220. In August 1973, Continental noted a "strong probability" that American and Gordon would be forced to withdraw from the marketplace resulting in an increase in Continental's market share of 5% to 6% (CX 7 (L–2)).

221. During the 1972–1973 period Gordon supplied branded bread to Hughes Markets' twenty-five stores (4936–37 A. Gordon; 5068 Prosser (including one in Oxnard)). In 1973 Continental offered Hughes a private label program and obtained the account. Continental was aware that the loss of bread table space at Hughes would put Gordon out of business. Hughes accepted Continental's offer of 17.5¢ for 1 lb. expanded bread (RX 278 A-E; 4796–99, 4840 J. Walsh). This account was projected to yield $10,000 weekly in sales (RX 278A).

222. An examination of Continental's Profit by Variety study relating to the Hughes private label account reveals that Continental was selling all of the products which Continental supplied under Hughes private label below fully allocated cost. Some of the items were close to being below variable cost as well (CX 441 K, T, Z–20, Z–28, Z–37, Z–42, Z–52, Z–137, Z–139, Z–220, Z–221).

223. In March 1974, Beverly Hills sales to Hughes totalled $65,303.18 of which $19,639.86 (29.66%) was for Wonder bread products. The sales of Wonder Bread (assuming a profit) would not have been enough to offset the unprofitable private label program sales (CX 461B; CX 493A).

224. On June 22, 1974 Gordon leased its baking plant to Certified Grocers in order to avoid going bankrupt (4510, 4520–21, 4575 A. Gordon). Thereafter Certified produced Springfield private label bread for the member grocers. The bread products produced by Certified included only white bread and bread type rolls and the Springfield label products were delivered on a store drop basis without returns by salaried employees, similar to the distribution methods of captive bakers, except that Certified did not control the shelf space of its members. (*See* 11334–46 Andikian; *see also* 10297 Jakacki). In addition, Certified sold some private label bread (other than Springfield), and solicited this portion of its business in competition with the other wholesale bakers (4608 A. Gordon; 11340–43 Andikian). Certified did not sell advertised label bread and did not sell to restaurants or institutional accounts (11337–38 Andikian).

225. Thus, in 1974, with the withdrawal of American from the grocery segment of wholesale baking and the withdrawal of Gordon from the advertised label business, Interstate and Continental became the dominent wholesale bakers in the Los Angeles area (4529–32, 4574 A. Gordon). Each had approximately 40% of the white bread market (4531–32 A. Gordon; *see* CX 493A). [51]

226. It is found that, during the period 1966 through 1974, Continental discriminated in price between purchasers of its advertised label bread and purchasers of its secondary label and its private label bread and that during most of this period the lower discriminatory prices were below Continental's fully allocated costs. In most instances, these lower prices were not granted to meet the equally low prices of any of Continental's competitors. It is found that Continental's pricing practices contributed substantially to the failure of Prosser, to the withdrawal of American from the wholesale bakery business, and to the transfer of Gordon's baking operation to Associated Grocers. As a result, the wholesale white bread market has become more concentrated, with two multiplant bakers sharing most of that market.

Northern California Marketing Area

227. Complaint counsel challenge certain pricing practices engaged in by Continental in the Northern California marketing area during the period 1972 through 1974. More particularly, complaint counsel challenge the low wholesale prices at which Continental sold private label products to chain store grocers throughout that marketing area from July 1972 until 1974 (CCPF 12–1–12–222; CC Mem. 129–137).

228. The Northern California marketing area included the San Francisco Bay area, the central valley of California from Fresno to

Reading as well as Reno and the Lake Tahoe area (7914 Stip.; *see* CX 781; 3251–52 Frielink).

229. Continental's San Francisco, Sacramento and Oakland bakeries sold bread products in this Northern California marketing area. These bakeries were part of Continental's Northern California Region (Redwood City) which also included bakeries located in Honolulu, Portland, Seattle and Spokane (3163 Frielink).

230. Other wholesale bakers in this marketing area in the early 1970's were Campbell-Taggart which had six plants, American, William Inglis and Sons Baking Co. ("Inglis") and Welsh Baking Company ("Welsh") located in Reno (3852 Albrecht; 3183–84 Frielink).

231. Continental's Oakland bakery produced variety and pan white breads. Its San Francisco and Sacramento bakeries produced cake products as well as variety and white pan breads (3162–63, 3175 Frielink; 4139–40 Heaps). In 1974, the San Francisco bakery was converted into a cake producing plant and Sacramento's cake production was transferred to the San Francisco bakery (3163 Frielink). These bakeries supplied bread products to each other (3161–63, 3175 Frielink).

232. Continental's advertised label was Wonder while its secondary labels were Country Style and Home Pride (3175, [52] 3180 Frielink). In 1970, Continental's private label customers were United Grocers, a voluntary cooperative of retail grocers ("Bonnie Hubbard" label) (3214 Frielink; CX 771A-B), Albertson's in California and Nevada (3185–86, 3218 Frielink), Wentz Markets, Cola Markets and Mayfair (CX 610A).

233. At all times relevant hereto, Continental sold bread products produced by its Bay Area bakeries to grocery customers located in Nevada (CX 610A).

234. In the relevant time period, Campbell-Taggart had two subsidiaries in the Northern California marketing area, Rainbo and Kilpatricks. Rainbo operated four plants located in Chico, Sacramento, Modesto and Fresno (3184 Frielink). Its advertised label was Rainbo. In late 1970, Campbell-Taggart was selling private label products to United Grocers and Farmers Market located in the northern part of the marketing area (CXs 771B; 610A).

235. Kilpatricks operated two plants located in San Francisco and Oakland (3184 Frielink; 4956, 4965 Roberts; *see* CX 785). Its advertised label was Kilpatricks (3356 Frielink). From 1970 to 1974 Kilpatricks sold private label to Alpha Beta (4961 Roberts).

236. In the early 1970's American had one bakery in the Northern California area located in San Jose. It distributed bread products throughout the Northern California Marketing area (CX 784; 3852 Albrecht). American's advertised label was Langendorf while its larg-

est private label customers were Mayfair and K Mart (CX 610A; 3336 Frielink).

237. Inglis had one bakery located in Stockton (CX 782; 3416–17 Sitter). This plant was rebuilt and modernized in 1957 and it used a continuous mix process (3717–19 W. Inglis). In 1966, Inglis acquired the Sunlite bakery located in San Jose, but transferred the production of that plant to San Jose in 1969 (3417 Sitter; 3728–29, 3753, 3784 W. Inglis). Inglis' advertised label was Sunbeam and it sold some bread products under the Sunlite label (3340 Frielink; 3416–17 Sitter; 3611 Jones). In 1970, its private label customers were Farmers market and Save Mart (CX 610A).

238. Welsh, located in Reno, sold bread products under the Welsh and Sheepherder labels (3340 Frielink; 3515–16 Biechner; 3956 McGinley. It was purchased by American in 1971 (3466–69 Biechner; 3957 McGinley). It had tried to enter the Sacramento area in the late 1960's, but was not successful (3466–69 Biechner).

239. Interstate, which had entered the Northern California market in 1954 by purchasing bakeries in Sacramento and Oakland, sold these bakeries in 1967 and 1969, respectively, and withdrew from the market (3941 Hunter). [53]

240. In October 1972, the approximate market shares of the wholesale bread market in the Northern California area were Campbell-Taggart 40%; Continental 30%; American 25%; and Inglis 5% (RX 103C; 4046 McCarthy).

241. Continental was considered to be a price leader in the Northern California area in that its wholesale price increases were usually followed by other wholesalers (3891–92 Johnson).

242. The principal captive bakers in Northern California in the early 1970's were Safeway, Lucky Stores and Alpha Beta (3228, 3353 Frielink; 3429 Sitter; 3871 Albrecht). By 1974, Safeway's market share of all white bread was 2.7% in the Sacramento area and 11.0% in the San Francisco/Oakland area. In 1974, Lucky Stores' share of the total white bread market was 9.0% in the Sacramento area and 6.8% in the San Francisco/Oakland area. Lucky Stores used the Lucky and Harvest labels. The combined shares of Safeway and Lucky Stores were 17.8% in San Francisco/Oakland area and 11.7% in the Sacramento area (CX 141).

243. From 1970 to 1974, the 1 lb. expanded loaf of white bread was the largest volume private label product in the Northern California area and was the focus of price competition among the wholesalers as well as the retail grocers (3514 Biechner; 3676 Jones).

244. Private label and captive label bread became an important factor in the Northern California market area in the latter part of the 1960's (3877–78 Albrecht). The first significant private label program

was the "Bonnie Hubbard" program which Continental negotiated with United Grocers Cooperative, the largest grocery cooperative in the Northern California market (3214 Frielink; CX 771A). Although the wholesale price for the 1 lb. expanded loaf of Bonnie Hubbard private label bread was originally announced as 20¢ with stale returns and 19¢ without stale returns, before the program started on July 1, 1968, Kilpatricks offered to sell its advertised label bread to Albertsons at 18¢. Continental lowered its price on 1 lb. expanded bread to 18¢ at the start of the Bonnie Hubbard program (4135–39, 4196 Heaps; 3214 Frielink; RXs 61A; 62). The other major wholesalers also lowered their wholesale price to 18¢ (RX 61A).

245. Continental supplied Bonnie Hubbard bread to United Grocer's members until mid–1970, when Campbell-Taggart replaced Continental (3214, 3333 Frielink; 4186, 4189–90 Heaps; CX 771A-B). Continental gave up the Bonnie Hubbard program because it was not profitable (3214, 3217 Frielink).

246. Continental actively sought private label business of the member grocers before and after its participation in the Bonnie Hubbard program (CXs 623A-B; 630A-B; 689A-B). From 1960 to mid 1970, Continental sold private label bread to various retailers at wholesale prices either identical to, or lower than, the price at which it sold Bonnie Hubbard label bread **[54]** (3216–19 Frielink; *e.g.*, CXs 604A-B; 605A-B; 606A-C; 607A-B; 613A-K).

247. As a result of the vigorous price competition among wholesale bakers the discounting of wholesale prices to retailers became prevalent (CXs 614A-C; 619A-C; 621A-B). Discounts were offered on private label as well as secondary and advertised label bread (3215–18 Frielink; CXs 610B; 759Z–24–Z–28; *see*, 4184–88 Heaps).

248. From mid-1969 until September 16, 1970, the prevailing wholesale price for 1 lb. expanded private label white bread was 17.2¢ per loaf. Inglis considered this price to be "below the cost of doing business" (RX 61A). From September 16, 1970, until July 10, 1972, the prevailing wholesale price for the 1 lb. expanded loaf of private label white bread was 18¢ (3376 Frielink; CXs 722; RX 2B).

249. On July 10, 1972, Continental reduced its wholesale price for the 1 lb. expanded loaf of private label white bread to 17.2¢ and this price was the prevailing wholesale price for over one year until August 20, 1973 (3221–25 Frielink; CXs 676; 722). This price was offered to all of Continental's private label customers in the Northern California market area as the company had maintained a single price policy for private label accounts since 1970 (3221 Frielink; 4149 Heaps). Such a uniform price for private label bread was unique to the Northern California market area. The other major wholesale bakers gave

private label discounts in meeting particular competitive offers (3618–19 Jones; 4007, 4013 McCarthy; 4962 Roberts).

250. Although Inglis, American and Campbell-Taggart (Rainbo Chico bakery) had sold 1 lb. expanded bread at prices below 18¢ before July 10, 1971, to several of their private label customers, these customers were located in a relatively small portion of the Northern California area (RX 31). None of the other wholesalers had offered the 1 lb. expanded bread below 18¢ to the entire Northern California market before Continental's offer of July 10, 1972 (CXs 647A; 676; RXs 90A-C; 31; 33–40; 63A; 3380–82 Frielink; 3460–61 Sitter; 3979–89 McGinley).

251. Although all of the wholesale bakers in Northern California had similar costs, it appears that Continental's costs during the period 1966 through 1972 were consistently higher than the industry average (CXs 747; 753 *in camera;* 3192 Frielink; 3607 Jones). Wholesale bakers' costs of producing and distributing white bread increased each year from 1966 to 1974 CXs 648F; 655; 687C; 688B; 689A; 691B; 747 *in camera;* 3265, 3373–74 Frielink; 3607–08, 3618, 3628 Jones).

252. In 1966, Continental stated that its fully allocated costs of producing and selling 1 lb. expanded white bread was 19.58¢ per loaf (CX 740A-B). Thus, from at least July 10, 1972, when it lowered the wholesale price of 1 lb. expanded bread to 17.2¢, Continental was knowingly selling that bread product [55] below its fully allocated costs in Northern California (*See,* 3214, 3217 Frielink).

253. Continental's losses (in thousands) on bread products during the years 1971 through 1974 were as follows (RX 3 (1971–1974); CX 1301C (1972 and 1974):

	1971	1972	1973	1974
Oakland	(66)	(141)	(435)	(416)
Sacramento	(32)	(199)	(645)	(639)
San Francisco	(192)	(470)	(1145)	(710)
Total	(290)	(810)	(2429)	(1765)

In four years Continental lost over $5 million on bread sales in Northern California.

254. American's plant in San Jose was an extremely efficient, highly automated, modern plant (3854 Albrecht). On May 9, 1973, American determined that the total cost of producing and selling 1 lb. expanded white bread was 25.53¢ (CX 751B). Accordingly, Continental was selling its 1 lb. expanded bread considerably below American's fully allocated costs (*Compare* CX 722 *with* 751B). In fact, assuming Continental's costs were comparable to American's, the 17.2¢ price was below Continental's average variable costs pursuant to the for-

mula adopted for this case in Finding 45, *supra*, (80% of 25.53¢ equals 20.42¢).

255. Inglis' production costs were lower than Continental's because it used the "continuous mix" process whereas Continental was using the "Continental brew process" (3199–3200, Frielink; 3724–25 W. Inglis). During 1973, Inglis' fully allocated costs of baking and distributing 1 lb. expanded white bread was between 25.3343¢ (January 1973) and 29.939¢ (September 10, 1973). Thus, Continental was selling its private label 1 lb. expanded bread at a wholesale price considerably below Inglis' fully allocated costs (CX 722; 3617–18 Jones).

256. During this time period, Continental guaranteed its wholesale prices to existing and prospective customers and predicted that the weaker companies would have difficulty surviving in view of the state of the market (CX 606B; 607A; 3267 Frielink). Also during this time period and through 1974, Continental specifically recognized that American and Inglis were continually growing weaker, that their financial condition was not stable and that it intended to eliminate certain of its competitors from the Northern California market or portions thereof (CXs 616D; 619A; 666B-C; 686; 688B; 4165–67 Heaps).

257. For example, in a 1974 business plan, drafted in 1973, Continental's San Francisco plant manager predicted that 1974 would present great opportunities. He stated that "[w]e are gaining more market domination for our products and as we do so, **[56]** our competitors fall back, and grow weaker" (CX 666B). Continental's regional business plan summary for Northern California predicted that "[c]urrent conditions in the industry may cause some bakers to close their plants." Continental's strategy was to "aggressively seek to increase sales tonnage through new varieties and through the assignment of specific target accounts to all sales management personnel" (CX 688B). In a 1974 business plan, dated June 23, 1977, Lund, manager of the Oakland bakery, targeted Louis Stores, an Inglis private label account, to advance Continental's private label program (CX 689B). In the same business plan Heaps targeted Save Mart, also an Inglis account, for Continental's private label business (CX 665G).

258. By 1972, Continental had acquired a number of chain grocers as private label customers. They included Brentwood Markets, Eagle Thrifty, Albertsons, Stop N Shop, Shop N Go, Ralphs, Bazar, Waremont, Wertz and Mayfair (CX 720; 3225 Frielink).

259. In response to private label offers to its customers by Continental before July 17, 1973, Inglis lowered its price to meet Continental's offers (*See* CXs 722; 669; 3495–3509 Biechner; 3609–10 Jones).

260. In November 1972, the Campbell-Taggart and Continental Bakeries were closed by a labor strike. American and Inglis supplied the Northern California market with bread products, although, dur-

ing most of the strike period, they only produced the 1 1/2 lb. advertised label loaf on which they made more profit than if they had produced private label or the 1 lb. expanded loaf of advertised label bread (CXs 2205C-D Jones; 2207F-G Albrecht).

261. On July 17, 1973, Inglis sent out a "discount elimination letter" to its customers in an attempt to increase its profits (3511–12, 3547–49 Biechner; CX 764). American was the only other major wholesaler to follow Inglis' price move. Inglis and American thereafter lowered their prices to the prevailing 17.2¢ wholesale price (3500–01, 3511–12, 3547–49, 3553 Biechner; 3627–34 Jones; *see* CX 764). At the time of Inglis' letter, Federal price controls were in effect (*See* RX 75).

262. In a period following the Inglis "discount elimination letter," Continental made a concerted effort to acquire private label business (RX 500G-I Letson; 4250–51 Konkel; 4389–92 Posesto; 4270–71 Teel; 4080–82 Miller; 3510 Biechner; *e.g.*, CXs 769Z–46; 769Z–50).

263. During all relevant times. Continental's wholesale prices for its advertised label bread was substantially higher than the prices for private label. For example, from July 10, 1972 until August 6, 1973, Continental's wholesale price for its 1 lb. expanded Wonder loaf was 25¢, and from August 6 until [57] August 20, 1973, its wholesale price was 26.5¢ (CX 721). During this period, its price of the comparable private label product was 17.2¢ (CX 722). During this period the difference in price between the 1 1/2 lb. loaves of white private label and advertised Wonder label was at least 9¢ (CXs 721; 722).

264. Inglis first began to experience serious financial problems in the late 1960's and in 1969 filed for bankruptcy under Chapter 11 proceedings. The Inglis family personally loaned the Inglis Company approximately $4.5 million in an effort to "save" the business (3734, 3739–40, 3770 W. Inglis). It was well known in the baking industry in Northern California that Inglis had failed to make a profit from 1965 to 1976, except for the year 1972 when it supplied bread products to retail grocers during the labor strike against Campbell-Taggart and Continental (*See also* 3761–62 W. Inglis).

265. During the early 1970's, American withdrew from seven major areas of the Northern California market, including Sacramento, Bakersfield, Reno, Ukiah and Ft. Bragg. Thereafter American concentrated its operations in the San Jose area (3957–59, 4005 McGinley; 4160 Heaps). In addition to the high costs of distribution, American attributed its territorial withdrawal to the long period of price erosion in Northern California (4006 McCarthy), lack of consumer acceptance, and the expansion of captive label bakeries (*See* 4006–07 McCarthy; 3961 McGinley).

266. Between 1970 and 1975 American's net bread sales decreased from approximately $21,000,000 to approximately $17,700,000. Conti-

nental's bread sales increased from approximately $16,600,000 to $21,600,000 (RX 115A). Campbell-Taggart's sales increased from approximately $26,400,000 to $60,700,000 and Inglis had a slight increase from $9,800,000 to $10,800,000 (RX 115A).

267. By 1974, the only two major wholesale bakers of white pan bread selling in the entire Northern California marketing area were Continental and Campbell-Taggart (4159–60 Heaps).

268. In 1975, Continental made a net profit for the first year since 1970 (RX 3). In 1976, Inglis withdrew from the market, Campbell-Taggart purchasing the plant and assets (9291 Frielink).

269. It is found that during the period 1972 to 1974, Continental discriminated in price between purchasers of its advertised bread and purchasers of its private label bread and that during most of this period the lower discriminatory prices were substantially below Continental's fully allocated costs. The lower prices were not made in good faith to meet the equally low prices of any of Continental's competitors. It is found that Continental's pricing practices contributed substantially to the failure of Inglis and that Continental knew or should have known that Inglis would be injured by its discriminatory sales below cost. As a result, the wholesale white bread market has become more concentrated. [58]

270. Complaint counsel also challenge certain wholesale price differences charged by Continental to certain customers in Nevada between 1972 and 1974 on 1 lb. expanded and 1 1/2 lb. loaves of white bread. More particularly, complaint counsel allege that price differences of as much as 12.4¢ (or 38%) between certain independent grocery stores on their purchases of 1 lb. expanded Wonder and 1 lb. private label bread sold to their chain store competitors had the adverse effects on competition between retailers proscribed by Section 2(a) of the amended Clayton Act (CCPF 12–187; CX 2101B Stip.).

271. Continental's private label customers in the Nevada portion of the Northern California market were Albertson's, Mayfair and Eagle Thrifty (3185–86 Frielink; CX 610). Continental's Wonder customers in Nevada included Clarkson's Market and Miller's Superette and Park Grocery stores (4498–4500 Clarkson; 4313, 4315 Miller).

272. Clarkson and Miller paid substantially more for their Continental-produced 1 lb. expanded Wonder label than did Albertson's, Eagle Thrifty and Mayfair for private label bread of like grade and quality. During 1972 through 1974, the difference in price ranged from 7¢ in January 1972 to 12.4¢ in February 1974 (CXs 674; 721; 722; 733; RXs 1; 2; *see also* CXs 631; 625; 636).

273. Bread was a high volume sales item for Clarkson's and 5% of its business was in sales of bread (4503–05 Clarkson). During 1972 to 1974, Clarkson's purchased only Wonder products from Continental.

Clarkson never received any discounts, rebates, free goods, or cash in connection with the purchase of Wonder bread. Continental never offered private label or secondary bread to Clarkson's (4500–04 Clarkson).

274. Clarkson's usually purchased between $400 to $600 worth of white bread each week, 60% of which was purchased from Continental (Clarkson 4500). Clarkson had an overall net profit objective of 2–3% and a few percentage points difference in the wholesale price of bread was important (Clarkson 4503–05).

275. Mayfair was the closest grocery store to Clarkson's, located approximately 1.5 miles away. Albertson's and Eagle Thrifty were approximately 2 miles from Clarkson's. Continental supplied Albertson's and Eagle Thrifty with private label bread from 1972 to 1974 and Mayfair from January 1972 until December of 1973 (4502 Clarkson; CX 720).

276. The Savetime Park Grocery (Park Grocery) and Superette are grocery stores in Sparks, Nevada, operated by Ben Miller (4312–13 Miller). From 1972 to 1974, Miller's two stores competed with the larger chains, including Albertson's and Eagle Thrifty (4319–25 Miller). There was a Safeway store across the street from one of Miller's stores (4318 Miller). **[59]**

277. During 1972 to 1974 all of Park Grocery's and Superette's purchases from Continental were packaged under the Wonder label (4313–16 Miller). Bread was an important item for these stores (4320–22 Miller). Miller's stores purchased approximately $1500 in white bread products each week. One third of that amount was Continental's Wonder bread (4315 Miller). Miller always paid the wholesale list price for Wonder white pan bread and never received any free goods or cash payments from Continental on his purchase of bread (4316–18 Miller).

278. From 1972 through 1974, there were times when Miller's stores had to sell bread at cost or below cost to meet the retail price of their chain store competitors, Eagle Thrifty, Albertson's and Safeway (4321–22 Miller).

279. It is found that Continental discriminated in price between competing grocery customers in the Nevada area, and that such discriminations were, at times, substantial. The lower discriminatory prices were granted on sales of private label bread to chain stores. It is found that the effects of such discriminations, when in the magnitude of 10 to 12¢ a loaf (or 30% to 35%), may be to substantially injure competition between grocers paying the higher price for advertised label bread and chain stores paying the lower price for private label bread.

Cleveland

280. Complaint counsel challenge certain pricing practices engaged in by Continental in Northeastern Ohio during the period 1970 through 1974. More particularly, complaint counsel challenge Continental's private label agreement with Pick N Pay and the effects of that agreement upon competition in the greater Cleveland marketing area (*See* CCPF 13-1-13-466; CC Mem. 138-166).

281. Continental's Akron and Youngstown bakeries were part of its Detroit region which also included bakeries known as Detroit Wonder, Detroit Hostess, Toledo Wonder, Toledo Hostess, Cleveland Hall, Columbus Wonder and Dayton Certified. Continental's Cleveland Hall bakery produced cake and sweet goods only (5173 Miller).

282. The other wholesale bakers selling white pan bread in the Northeastern Ohio area in the early 1970's included Interstate, American, Ward, Laub, Schwebel, Nickles, Orlando, Tonys, Genest, Firth and Keystone (5194-95, 5216-18 Miller; 5278 Schreck; 5537 Stonbraker). The major wholesaler bakers in the Cleveland area were Continental, Interstate, Ward, Laub and Nickels (9352 Gase; *see* 5194 Miller; 5318 Meehan; 5387 Kravitz). American was not considered to be a factor in the Cleveland market (5538 Stonbraker). Nickels and Orlando, a small baker of specialty items, sold primarily to the restaurant trade in the early 1970's (5705-06 Bronczek; 9353 Gase; 5537 Stonbraker). **[60]**

283. The Akron and Youngstown market areas were considered separate from the Cleveland Market. Competitors, competitive conditions and prices sometimes varied from area to area during 1970 through 1974 (5194-95, 5216-18 Miller; 5248-50 Shreck; 9361 Gase). In Akron, the major wholesale bakers were Continental, Nickels, Schwebel, Millbrook, American and Ward (9358-59 Gase; *see* 5195 Miller). In Youngstown, the major wholesale bakers were Schwebel, Continental, Nickels and Keystone (9359-60 Gase).

284. In the early 1970's, the Akron bakery used a continuous mix process and baked only white bread (9361 Gase; CX 993"S" Davis). It ran approximately 100 bread routes from its plant or from agencies located in the Ohio communities of Cleveland, Canton, Mansfield and New Philadelphia (CXs 992L, 993D Davis; 5160-70 Miller). In 1971, the Akron bakery's bread sales were approximately $110,000 per week (5207 Miller).

285. The Youngstown bakery used a conventional mix process and baked hot dog and hamburger rolls and a wide assortment of variety breads (9361 Gase). It ran bread routes from the plant and from agencies located in Vanport and Franklin, Pennsylvania and Andover, Ohio (CX 922J; 5233 Shreck;). Approximately 70% of Young-

stown's sales were to grocery customers (5232 Shreck). In 1973, Youngstown's weekly route sales of white bread were approximately $35,000 (5236 Shreck).

286. Continental's Akron and Youngstown bakeries supplied each other with products and they were also supplied with additional varieties by other Continental bakeries (5259–62 Shreck; 5171–74, 5183, 5198–5200 Miller).

287. The Akron bakery sold bread products under the Wonder, Wonder Country Style, Home Country Fair, Nancy Martin and Edwards labels (CX 2695; 5188–90, 5192–93 Miller). It sold private label products to the following chain stores: Pick N Pay, Stop N Shop, Open Pantry, T&A Saveway; Acme and Stop-N-Go (*See* CCPF 13–85 - 13–98).

288. Interstate purchased Nabisco's Bread Division in 1968 (5301–01 Meehan). Its Cleveland plant is usually referred to as the "Millbrook" plant (5302 Meehan). This plant used a continuous mix process (5303 Meehan; *see* 9462 Gase). In 1973, it had approximately 68 routes, none of which were exclusively restaurant routes. The greater portion of its sales were in Cuyahoga County, Cleveland (5309 Meehan). It sold bread under the Millbrook and Good Cheer labels as well as private label bread under the Convenient, Stop N Shop and BiRite labels (5311, 5468–69 Meehan). Millbrook's largest selling loaf size was the 22 oz. loaf, which was 2 oz. lighter than other wholesale bakers' popular 1 1/2 lb. loaf (5480 Meehan). [61]

289. Laub, which was owned by the Georgetown Investment Company in 1970, had three bakeries (5528 Stonbraker; *see* RX 305). The Toledo bakery was fully automated and baked only white bread (5529 Stonbraker). Its Sandusky bakery produced only hot dog and hamburger rolls (5528–29 Stonbraker). The Cleveland plant was a conventional mix plant and produced mainly variety breads and rolls (5528 Stonbraker). In 1971, Laub had approximately 40 restaurant routes and 70 grocery routes in the Cleveland area. Approximately 58% of its sales were to restaurants, and included such products as hard rolls, buns, club bread, special sandwich bread, Jewish sour rye and pumpernickel (5533–34 Stonbraker; *see* 5701 Bronczek). Laub's largest volume product sold to grocery stores was a 20 oz. open top loaf of white bread. It also sold a 1 1/2 lb. open top loaf and a 1 1/2 lb. sandwich loaf, as well as many ethnic breads (5535 Stonbraker; *see* 9380 Gase). Laub had the most extensive commercial line of bread and roll products in the Cleveland area (5779 Bateman). Laub had sold private label bread to Savemore, but lost that account to Ward in 1972 (5608 Stonbraker).

290. Ward had a bread bakery in Cleveland. That plant operated at a loss prior to June 1973 (5756 Bateman). It was operating two full

shifts at that time (5774 Bateman). During the period June 1972 through June 1973, Ward had gained some grocery store business and reduced its losses "quite a bit" (5783 Bateman). Ward closed its Youngstown bakery in 1971 and its Cleveland bakery in 1978 (*See* 5368 Parks). It continued to supply its customers in the Cleveland area from its Toledo and Detroit bakeries (9425–26 Gase).

291. American had a cake plant in Cleveland and bread plants in Akron and Toledo. In 1973, it closed the Akron plant (5538 Stonbraker).

292. Schwebel was located in Youngstown and sold bread and rolls, hard rolls and hearth products in the Ohio communities of Youngstown, Niles, Warren, Canton and Cleveland. When Laub closed in January 1974, Schwebel entered the Cleveland restaurant market at the request of some customers who did business with Schwebel in Youngstown. Schwebel operated four restaurant routes from its Cleveland depot (*See* 5808–16 Schwebel).

293. Nickels, headquartered in Warren, Ohio, had five plants by the end of 1974. They were located in Navarro, Lima and Martins Ferry, Ohio, and Elkhart, Indiana, and in 1974 it purchased Tony's bakery, located in Fremont, Ohio, near Sandusky. Although Nickels sold a small quantity of bread products to grocery and restaurant customers in Cleveland prior to 1974, it increased its Cleveland restaurant business after Laub closed its bakery (5893–98, 5901 Gerber). Tony's bakery may have made some sales in Cleveland (5895, 5900 Gerber).

294. Genest Midwest took over the Bond Baking Company of Canton, Ohio, in the early 1970's (5898–99 Gerber). Genest [62] withdrew from the Cleveland area in 1970 or 1971 and went out of business in Canton in 1972 (5899 Gerber; *see* 5217 Miller).

295. The record contains little information on Keystone or Firth except that these bakeries were located in Pennsylvania and that they sold bread products in the Youngstown market area (5275, 5279–80 Shreck; CX 994A-F Fischer).

296. In 1971 Millbrook was the leading wholesale baker seller of white bread to grocery stores in the Cleveland area. Ward was second and Continental and American were tied for third and Laub was last (9352 Gase; *see* 5194 Miller; 5318 Meehan; 5387 Kravitz). Laub was the leading seller of white bread to restaurants with over 50% share of that market. Ward was second with 20% and other wholesalers had the remaining business (5705–006 Bronczek; 9353 Gase). Continental was the leading seller in the Akron area, having a slight edge over Nickels (9358–59 Gase; *see* 5195 Miller). In 1971 Schwebel led Continental in sales in the Youngstown area (9359–60 Gase).

297. In 1970, the following chain stores operating their own captive bakeries did business in Northeastern Ohio: Pick N Pay, Fisher-Fazio,

A&P, Kroger and Lawsons (9352, 9431, 9435 Gase; 5315 Meehan; 5219–22, 5225 Miller). Pick N Pay and Fisher Fazio were the largest chain stores. Combined they accounted for over 50% of the grocery store sales in the Cleveland market area (CX 968C, F; *see* 9429–30 Gase; 5380 Kravitz). Other major chain stores were Stop N Shop, L'il Shopper, Savemore, BiRite, Heinen's, Open Pantry, Eagle, Super Value, Convenient East, Convenient West, and K Mart (5309–10 Meehan; 5535–36 Stonbraker).

298. The most popular loaf sizes of advertised bread in the northeastern Ohio area were the 20 oz. loaf of white bread and the 1 1/2 lb. loaf of white sandwich bread (9490 Gase; *see* Stonbraker). The most popular private label white bread were the 1 lb., the 20 oz. and the 1 1/2 lb. loaves (CX 2695; CX 261B, E; 5419–20 Kravitz).

299. During the period 1971 to January 1974, Continental was never the price leader upward in the Cleveland market in either the grocery trade or the restaurant trade (5544 Stonbraker). Generally, a major wholesale baker could not charge a higher wholesale price that other wholesale bakeries without losing substantial sales (5216, 5225 Miller). However, for a period of approximately a year, Millbrook did sell bread for a 1¢ higher wholesale price than Continental (5370 Meehan).

300. In 1967, five of the major bakeries in Northern Ohio were indicted for conspiracy to fix prices (RX 301A-E). A civil action was filed simultaneously by the Department of Justice, also alleging a price-fixing conspiracy (RX 302A-G). In 1969, both actions were settled (RX 302H-Q). Cleveland was a static bread market in the early 1970's and the volume of bread sales by the two principal captive bakers (Pick N Pay and Fisher [63] Fazio) was increasing (5613–14, 5619 Stonbraker). The spread between the retail price of advertised bread and captive label bread was increasing (5614–15 Stonbraker). There was excess bread bakery capacity that could service the Cleveland market, especially Continental's Akron bakery which was operating at about 50% of capacity, *i.e.,* one and 1/4 shift (5619 Stonbraker; 10047 Signore; CX 2634A-B; CX 2633A-F) The restaurant business, especially the fast food segment, had been growing (5658 Stonbraker).

301. In mid–1971, Continental began an aggressive program to increase its restaurant and institutional business in the Cleveland market by offering products at prices reflecting substantial discounts from its list prices (9383–84 Gase; 5545 Stonbraker; 5675 Bronczek). In this way Continental acquired the business of several large accounts previously serviced by Laub or Ward (5677 Bronczek). For example, Continental acquired the business of Interstate United at Cedar Point, an amusement and recreation facility located near San-

dusky, Ohio, for the summer season of 1972, by offering a 12% discount from 1970 wholesale prices ostensibly meeting Laub's price offer (5551 Stonbraker; *see* CX 956A-B). Bronczek testified that Laub never offered such a discount (5680). Continental supplied bread and hamburger and hot dog rolls from its Toledo bakery. Laub had supplied Cedar Point with bread from its Toeldo bakery and buns from its Sandusky bakery (5553 Stonbraker). Continental retained the Cedar Point business in 1973, offering a 15% discount (*See* CX 2101A-B). In the 1970's, that account was a high volume account for the five month resort season worth approximately $50,000 annually to the bread supplier (11455–56 Bell; 5556 Stonbraker).

302. Laub also lost the Sky Chef account to Continental which offered a 12% discount (5557 Stonbraker). Laub had not offered Sky Chef a 12% discount (5573 Stonbraker; *see* CX 909 (136)) and Bateman testified that Ward had not offered Sky Chef a 12% discount (5757). That account was worth about $26,000 a year in sales.

303. Laub also lost the following accounts to Continental and the annual volume of sales listed: Hospitality Inns - $18,000 (5574 Stonbraker); Ponderosa Chain - $104,000 (5575–78 Stonbraker); and Red Barn - $30,000 (5683–84, 5677 Bronczek). Laub also lost other restaurant and institutional accounts on the basis of price (5685, 5696 Bronczek; 5579, 5582, 5584–87 Stonbraker). During this period Laub discontinued 8 restaurant routes, reducing its total routes to 54 grocery-restaurant combination routes (5588 Stonbraker), whereupon Continental increased the number of its routes from 1 to 13 (5589 Bronczek).

304. After 1970, the wholesale bakers granted discounts to their grocery and restaurant customers on advertised label products. Millbrook's usual discount was 5% to meet competition (5322, 5326–29 Meehan; *see* CX 931A-Z-21). Interstate [64] granted Pick N Pay a 12% discount directly from its Kansas City office (5328–29 Meehan). Laub also granted a 5% discount to selected customers, although it would grant up to 10% to meet competition (5543 Stonbraker; 5683 Bronczek; *see* CX 962A-N). Gase testified that Laub had the "cheapest prices in town" (9381). Ward reduced its discounts in November 1972 (5785 Bateman). Genest was considered to be a price cutter in the Cleveland market before it withdrew in 1970 or 1971 (5541 Stonbraker).

305. Continental learned, in early 1972, that Pick N Pay was considering closing its captive bakery and buying private label bread products from a wholesale baker (*See* CX 968C). At that time Continental was seriously considering closing its Akron and Youngstown bakeries. The Akron bakery, which was operating at about 50% capacity, was operating at a pre-tax loss of over $3000 per week (CX 2634A-B; CX 2633 A-F). Signore, Regional Vice President of Continental's Detroit region, opposed these closings (CX 2635A-B; *see* CX

2633A-D). In his view a Continental private label program for Pick N Pay would create a substantial profit for the Akron bakery and "would completely open up the Cleveland marketing area and would, in fact, make [Continental] the [dominant] factor on the market" (CX 2683B).

306. National Supermarket's purchase of Pick N Pay delayed Continental's negotiations for the private label business (*See* CX 969H; *see also* RX 304). In fact National Supermarkets contacted Continental about the private label subject before the purchase (9966–67 Vail). After Kravitz became president of Pick N Pay, Vail and other Continental personnel from Rye Headquarters and Signore had many discussions with Bogomolny and Kravitz (9986 Signore; *see* 9974 Vail; 5397–98 Kravitz; *see also* CX 835). One specific condition for any private label arrangement, as conveyed to Vail, was that Continental (or any other wholesale bakery that obtained Pick N Pay's private label business) would have to compensate Pick N Pay for the value of its captive bakery (9968, 9971 Vail).

307. Thereafter Signore became Continental's principal negotiator (9986, 10032 Signore; *see* CXs 886, 85, 807, 836). Although the early discussions contemplated delivery of private label products to Pick N Pay's Cleveland warehouse for store delivery by Pick N Pay, later negotiations centered on a store door delivery of private label products by Continental. Store door delivery by a wholesale baker became feasible when Continental secured a modification of the wholesale bakers contract with the local Teamsters Union that would permit any wholesale baker in circumstances where a captive bakery ceased operations, to make store door delivery by salaried employees, instead of employees working on commission (9986–88 Signore; 9399 Gase; 5871–73 Bogomolny; *see* CXs 805A, 809).

308. Signore was of the opinion that Laub, Omar (Fisher Fazio's captive bakery located in Columbus, Ohio), Ward, Nickels and Schwebel were capable of supplying Pick N Pay with private [65] label bread (9990). Millbrook was not considered to be in a position to supply private label to Pick N Pay because it was operating at full capacity (9989–90, 10051 Signore). Continental's Akron bakery was 29 miles from the Pick N Pay warehouse. Continental believed that it had the best capability in the area to produce the volume of bread products necessary to supply Pick N Pay with private label (CX 968D, G).

309. During the negotiations between Continental and Pick N Pay, Continental personnel were advised by Kravitz that Pick N Pay had received offers for the private label business from other bakers at prices lower than those offered by Continental (9992, 9994, 10051 Signore; *see* 9982 Vail). Most of these offers had been made in 1972 when warehouse delivery was being discussed (*See* 9993, 10031 Si-

gnore; 5394, 5446 Kravitz; 5817 Schwebel; 5868 Bogomolny; CXs 809, 884). The record shows that Omar, Ward, Laub, Millbrook, Schwebel, and Nickels, as well as Continental, had responded to Pick N Pay's request for bids in 1972 (*See* 5393–95; 5408 Kravitz; 5817 Schwebel; 5869 Bogomolny; CX 884). Signore did not know the details of the offers made to Pick N Pay by any of the other wholesale bakers (9994, 10031 Signore).

310. Although there was some delay in the negotiations in early 1973, Vail was confident that Continental would be Pick N Pay's supplier of private label bread (CX 884). By June 1973, Continental was the only serious contender for this business. Bogomolny testified that Continental's proposal "overall was a lower price proposal than the others" (5870). Laub had not made an offer on the store door delivery arrangement in June 1973 (5594–95 Stonbraker; 5451 Kravitz; 5883 Bogomolny). Omar had not made a firm proposal with prices for store door delivery (5881 Bogomolny). In any event, Pick N Pay had substantial misgivings about placing itself in a position of dependence for bakery products on its principal competitor, Fisher-Fazio, for which Kravitz and Bogomolny had once worked (5869, 5880 Bogomolny). Neither Ward nor Millbrook had pursued the matter after their initial response to Kravitz (5777 Bateman).

311. On July 13, 1973, Pick N Pay and Continental finalized their private label agreement. The written agreement (CX 803) detailed the varieties to be provided by Continental under the Edwards label drop shipped to the store door and established the following prices for the white bread products:

Variety	Price
1 lb. White Bread	$.145
1 1/4 lb. White Bread	.1575
1 1/2 lb. White Bread	.19
8 Pack Hamburger Buns	.17
8 Pack Hot Dog Buns	.17

312. The agreement provided that the private label products would be of a quality comparable to Continental's Wonder [66] products. It also provided that Continental would supply a full-time merchandiser to promote and develop the full potential of Pick N Pay's Bakery Department. It provided for an increase (or decrease) in the price of the private label products if flour prices rose (or fell), the amount of price increase (or decrease) to be determined each quarter by a specific formula. This clause was subsequently revised by oral agreement to provide for review of flour costs on a monthly basis (CX 2608F). The agreement also provided that it would remain in effect for three years

and was renewable, although it could be terminated by either party with 90-days advance notice.

313. Not mentioned in the agreement was Continental's commitment to reimburse Pick N Pay for promotions of private label products commensurate with the estimated book value of the Pick N Pay bakery (*See* 9971–73, 9982 Vail; CX 984A-C, *in camera*). Continental actually paid Pick N Pay approximately $210,000 as promotional allowances, sometimes referred to as "proof of performance", from 1973 through the first three months of 1976 (CX 2682; 984A-C *in camera;* 2602A-B *in camera*). Continental also provided Pick N Pay with unit billing, which was a billing by specific varieties (10035 Signore). Continental also hired Bill Owens who had handled Pick N Pay's bakery order desk. Thereafter he performed the same service for Continental in handling the Pick N Pay account (10017 Signore; 9406 Gase).

314. Other verbal arrangements not mentioned in the agreement included a 2¢ allowance to Continental for transportation and delivery of Pick N Pay's outside purchases of certain private label products, the agreement that Continental would lease Pick N Pay's transport truck and bread racks and dollies for three years and the provision that Continental would pay rent for the Pick N Pay warehouse for one year (CX 2603G; *see* 10021–22, 10033–34 Signore; 5412 Kravitz; 9407–09 Gase). Continental also agreed to provide the Pick N Pay stores with cake display racks at a total cost of $19,000 (CX 800B). Continental was also obligated to deliver to Pick N Pay stores certain private label sweet good products that Pick N Pay was purchasing from other suppliers, the largest, Big Bear, located in Columbus, Ohio (10020–21 Signore; 5418 Kravitz).

315. According to Continental officials, studies conducted by the Detroit Regional office and Rye Headquarters during Continental's negotiations with Pick N Pay (studies which could not be located during this litigation) showed that the Pick N Pay private label business would be profitable to Continental on the basis of fully allocated costs (9996–10002 Signore; 9402 Gase). Continental had expected to make a "profit" of $6000 to $7000 per week on sales of private label to Pick N Pay (10002 Signore; CX 883C; *see* CX 805A). His estimate was for Akron and the other three plants producing Pick N Pay private label products, but did not include full fixed overhead costs (CX 2639R). In addition, it did not include the "proof of performance" payment of approximately $70,000 per year, and did **[67]** not include certain costs that would be incurred using the Pick N Pay warehouse, equipment and trucks.

316. Meehan testified that he doubted whether Millbrook could have made a profit if it sold 1 lb. bread at 14.5¢ per loaf (5334; *see* CX

930A-C, E). Stonbraker testified Laub could not have made a profit on store delivery at that price (5598; CX 849A-N). Bateman testified that Ward could not have made a profit at the prices quoted in CX 803, if it had selling and delivery costs (5768–69).

317. Continental, as Pick N Pay's private label supplier, acquired the first position on the bread table (after the private label bread) for its advertised bread, which amounted to one half of the space allotted for all advertised bread (5457–58 Kravitz; 9412–13 Gase; *see* 5890–91 Bogomolny). In addition, Continental received authorization for a number of Wonder varieties that it had not theretofore been selling to Pick N Pay (9930–31 Dierker; 10026–27, 10047 Signore; 9412–13 Gase). The volume of sales in Wonder bread products increased approximately $20,000 per week (10027 Signore; 5891 Bogomolny; CX 845A-C).

318. The resetting of the bread table in the Pick N Pay stores after Continental became the private label supplier was still controlled by Pick N Pay (5888 Bogomolny; 9411 Gase; 5410, 5448 Kravitz; 10016, 10023 Signore). Less space was allocated to the Edwards label than had been allotted for Pick N Pay's captive label (10027 Signore). Millbrook lost its number one position for advertised bread to Continental and lost a considerable amount of shelf space (5338 Meehan; 5415, 5450 Kravitz). Although Laub gained both space and authorization for varieties, it did not sell popular loaf sizes of white bread to Pick N Pay (5590–91, 5602–03 Stonbraker; *see* 5888 Bogomolny; 10024 Signore; 9413 Gase; RX 3009B-Z–122). Laub had complained to Pick N Pay about its shelf space assignment and because of a long time friendship between Kravitz and Beyer, Laub's president, Laub was given more rack space (5416, 5450–51 Kravitz; 10024 Signore; *but see* 5633 Stonbraker). Laub's sales to Pick N Pay in all products dropped from over $10,000 per week to $7,000 per week (5603 Stonbraker; *see* RX 3009B-Z–122). Laub's sales of its large white bread milk loaf dropped from over $1200 a week to under $900 per week (*See* RX 3009B-Z–122). Stonbraker testified that Laub also lost important exposure to the consumer for its advertised products in Pick N Pay stores (5605).

319. The distribution of private label products to Pick N Pay turned out to be much more expensive than Continental had anticipated (9409 Gase). Because of limited loading facilities at the Akron plant, Continental had to use the Pick N Pay warehouse as a depot from which to deliver the private label products to the Pick N Pay stores (*See* 9404–06 Gase). There was an "explosion of orders" both on sweet goods and in private label bread (10020 Signore). The volume of Big Bear sweet goods purchased by Pick N Pay was three times the amount [68] forecast and Continental was required to use more trucks

and more employees to handle this product (10021 Signore; 9404–06 Gase; CX 976B, *in camera*). Because of Pick N Pay's special promotions on its private label products, the volume of white bread was also greater than forecast and Continental was required to run two shifts at its Akron plant on overtime on numerous occasions (10039–42 Signore; *see* 5419 Kravitz; CX 976B, *in camera*). In addition, the price of flour, as well as other ingredients, and the price of gasoline and production energy increased dramatically (5336 Meehan; 5424 Kravitz; CX 976A-B, *in camera*). Continental experienced some service problems in its delivery of private label products to the Pick N Pay stores (10044 Signore).

320. After a couple of months it became apparent that the Pick N Pay program had not realized the profit that was expected to show (CX 882). In the fall of 1973, Continental began a series of studies of its Pick N Pay business (*See* CXs 2628; 882). One of the first studies revealed that during the four week period ending August 25, 1973, the Akron Bakery sustained a $16,000 loss on its Pick N Pay business (CX 800B).

321. Only three Pick N Pay private label varieties showed a positive profit after variable costs, although these three varieties, all produced at Akron, accounted for 42% of the total Pick N Pay private label sales (CX 800C). Ingredient prices had a dramatic effect on Akron profits. Before production for Pick N Pay began the average price of ingredients was 9.3¢ per lb., but in August the average price of ingredients was 11.16¢ per lb. (CXs 800C; 2639R, T; *see also* CX 883A-C).

322. Three Continental Form 452Bs dated December 28, 1973, showed that Continental's prices to Pick N Pay on the 20 oz. loaf of white bread and the 24 oz. of white sandwich bread were below incremental costs (CX 2632C-F), whereas the price to Pick N Pay on the 1 lb. loaf of white bread was below fully allocated costs but above incremental cost (CX 2632A-B). A similar analysis on the Pick N Pay private label bun products produced at the Youngstown bakery shows that the 8 pack hamburger buns and 8 pack hot dog buns were sold below full cost, but above incremental costs (CX 2639H-K).

323. On March 1, 1974, Continental moved from the Pick N Pay warehouse to another facility in Cleveland, ceased paying for temporary employees and began using its own vehicles and drivers for redistributing private label products to the Pick N Pay stores (CX 2639S).

324. Continental's in-depth analysis of the Pick N Pay account covering a four week period during May 1974 showed sales below cost on almost all private label varieties (CXs 2663C-N; 2664A-D; 2665A-B; 2673–75). This analysis showed a total unfavorable figure of $38,550 for the private label segment of the Pick N Pay account (CX 2663D).

At that time the wholesale prices of the three Pick N Pay private label varieties produced [69] at the Akron bakery were as follows (CX 2673 A):

16 oz. White	.1825
20 oz. White	.1950
24 oz. Sandw	.2275

The sales to Pick N Pay of these three items shows a total unfavorable figure of $33,528 (CX 2673A). According to Frederick Breines, on an incremental basis, Continental "basically broke even on the total [Pick N Pay] business" showing a $16,000 loss on Pick N Pay private label and a $15,100 profit on sales of branded products (*See* CX 2608B). In his opinion, the loss on private label products, both produced and purchased, resulted from not charging high enough prices to recover transportation, warehouse, delivery and administrative expenses (CX 2608C). Since the contract was signed in July 1973, there had been three price increases totalling 3.75¢ per unit (CX 2608E). In making this analysis, Breines was not aware of the "proof of performance" payments that were to be made to Pick N Pay at a rate of about $70,000 per year (*See* CX 2693A-B).

325. According to Breines, Continental would have to obtain a net price increase of 4.28¢ per unit to break even on the Pick N Pay private label products produced by Continental (CX 2614A; *see also* CX 2636T).

326. Following a meeting in mid June 1974 between Vail and Kravitz, Gordon Thomas, by letter dated June 27, 1974, made Continental's proposal for a renegotiated agreement. Although containing most of the provisions of the July 1973 agreement, this proposal incorporated a more sophisticated formula for price changes, relating to all costs on products produced by Continental including ingredient cost changes in sugar and shortening, as well as flour. Ingredient cost were to be calculated every month and other costs calculated quarterly. The proposal also provided for actual costs incurred in transporting private label products that Pick N Pay purchased from other suppliers. The proposed agreement also contained a provision that Pick N Pay would notify Continental three days in advance of any special promotion of private label products (CX 975A-D *in camera*). The base prices for June 1974 set forth in the proposed agreement were as follows (CX 975B *in camera*):

Variety	Base Price
1 lb. White Bread	.2244
1-1/4 lb. White Bread	.2407
1-1/2 lb. White Bread	.2829

327. In Continental's analysis of its June 1974 business with Pick N Pay, the private label products produced by Continental showed an unfavorable result of $40,884 or a loss of 4.34¢ per unit (CXs 2679A-B; 2680A-D). [70]

328. After extensive negotiations and exchanges of views and information (*See* CX 2607A-C; CXs 979A-D - 983 *in camera;* 2616, 2617), Continental and Pick N Pay entered into an amended agreement on September 25, 1974, to become effective on October 7, 1974 (CX 829A-H). This amendment generally adopted the features contained in Thomas' proposal of June 27, 1974 (CX 829D; *see* CX 2616B). The base prices on Pick N Pay label products were established as follows (CX 829B):

Variety	Base Price
1 lb. White Bread	.1792
1 1/4 lb. White Bread	.2117
1 1/2 lb. White Bread	.2242

329. In his memorandum dated August 26, 1973, explaining the possible impact of this agreement on annual profits before taxes, Breines had presented the following projection to Continental's top officials (CX 2616A):

	Annual PBT Full Load	($000's) Direct only	Direct Plus Plant Overhead
Private Label Produced	$(139)	$204	$(75)
Branded	135	200	135
Total	(4)	$404	$60
Memo: Proof of Performance	$(70)	$(70)	$(70)

It should be pointed out that this is the first analysis of Continental's Pick N Pay business in the record in Docket 9000 in which the "proof of performance", *i.e* promotional payments, is included. In a recently discovered document it appears that Breines first learned of the arrangement about June 11, 1974 (*See* CX 2693A-B).

330. Breines also reported (CX 2616B):

> The prices negotiated represent an average increase of .67 cents on all products except 20 oz. white, 20 oz. butterball and the 8 cl. hamburger buns. On these items we negotiated a 2.67 cent increase on the 20 oz. white (48.8% of total volume) and the butterball

(6.1% of total volume) and a 1.33 cent increase on the 8 cl. hamburger bun (11.9% of total volume).

331. In his suggestions as to additional areas for profit improvement under the topic "Better Mix Management", Breines stated (CX 2616C):

> On a full load basis we have approximately five products that are either breaking even or making 8.0 to 13.4% profit based on the new pricing. Three of these items are "variety products"—family rye, hearty rye and wheat bread. The other two products are 16 oz. [71] white and 8 cl. egg hot dog buns. These items now only account for 21.7% of the total mix.

332. After the modified agreement was executed, the prices to Pick N Pay were adjusted monthly pursuant to the formula set forth therein. The price changes for Continental-produced product may be summarized as follows (CX 974A-R, *in camera*):

	10/21/74	12/16/74	1/20/75
1 lb. white	.1845	.1863	.1920
1-1/4 lb. wh.	.2180	.2201	.2268
1-1/2 lb. wh.	.2308	.2331	.2402
8 Pk Ham	.2239	.2261	.2330
8 Pk. Hot	.2102	.2123	.2188
	2/17/75	3/17/75	4/9/75
1 lb. white	.1960	.1937	.1904
1-1/4 lb. wh.	.2316	.2289	.2250
1-1/2 lb. wh.	.2452	.2424	.2383
8 Pk Ham	.2379	.2351	.2312
8 Pk Hot	.2234	.2208	.2170

333. Continental's analysis of the Pick N Pay private label business for five weeks in December 1974 covering Continental-produced product showed a loss of $34,588. The wholesale value of these products was $221,444, the "cost to doors" was $212,606. Distribution costs totaled $38,992 (CX 2678A-B).

334. Analysis of Continental's Pick N Pay private label business for January 1976 showed a full load loss before taxes of $25,500 and an incremental profit before taxes of $14,300. Continental's overall business in private label and Wonder/Hostess label showed a full load loss before taxes of $17,100 and an incremental profit before taxes of $51,700 (CX 2690 A-B; *see* CX 2669 A-C, CX 2670 A-G). The work sheets also showed that Continental's prices on the 24 oz. Giant Sandwich loaf and the 8 Pack hamburger buns were below Continental's incremental costs (CX 2669A).

335. Work sheets covering the first three months of 1976 showed

that Continental's prices were also below incremental costs for three other bun varieties baked by the Youngstown bakery (CX 2668B).

336. Statistics for July 1976, showed a loss on the private label Pick N Pay business in Continental produced product on both a variable and full load basis (CX 2661C). Statistics for August 1976, showed a loss on a full load basis and a profit on a variable cost basis (CX 2686A-B). [72]

337. During the period 1971 - 1979 quarterly sales by Continental to Pick N Pay may be summarized as follows (CX 2686 A-B):

Sales Period	Bread Sales to Pick N Pay	
Ending	Main Line Quarterly	Private Label Quarterly
12/11/71	$ 48,373	-
6/10/72	30,433	-
12/3/72	33,566	-
6/23/73	28,925	-
12/15/73	140,075	$654,316
6/22/74	125,788	723,099
12/14/74	143,117	541,229
3/26/75	107,900	520,700
6/30/75	115,400	687,500
9/24/75	125,300	591,000
12/25/75	133,400	595,800
3/26/76	141,700	541,400
6/25/76	150,000	581,800
9/24/76	243,600	606,200
12/31/76	259,000	610,200
3/26/77	239,500	603,700
6/25/77	255,800	602,100
9/24/77	266,800	791,400
12/31/77	299,800	672,500
3/31/78	257,700	575,200
7/1/78	271,300	661,900
9/29/78	259,600	605,600
12/30/78	273,500	568,000
3/31/79	284,600	500,200
6/30/79	315,100	562,600
9/29/79	319,200	553,400
12/29/79	325,800	566,600

338. During 1973 and 1974, Continental sold its advertised label bread (Wonder) to a number of chain stores located in Northeastern Ohio, most of which were in direct competition with Pick N Pay. The 14.5¢ price on a 1 lb. white bread afforded Pick N Pay was not offered to any other customer of the Akron plant in July 1973, nor was the opportunity to accept store door delivery optional for all customers (CX 993M-N Davis).

339. The wholesale list prices on branded products may be summarized as follows (*See* CX 912):

	12/27/72	5/23/73	7/25/73
1 lb. Country Style	.24		.265
20 oz. White	.34		.355
24 oz. White	.37		.385
8 pk. ham	.34	.355	
8 pk. dog	.34	.355	

	8/17/73	11/12/73	1/14/74 [73]
1 lb. Country Style	.295		.31
20 oz. White	.395		.405
24 oz. White	.425		.435
8 pk. ham		.39	.405
8 pk. dog		.39	.405

	2/18/74
1 lb. Country Style	
20 oz. White	
24 oz. White	
8 pk. ham	.435
8 pk. dog	.435

340. Pick N Pay promoted Edwards label bakery products weekly (10025 Signore). Meehan testified that the retail price of Pick N Pay's private label bread was "more competitive" after Continental began supplying it and Pick N Pay ran more promotions on its private label bread (5341–42). Stonbraker testified that retail price competition between Pick N Pay and Fisher-Fazio immediately after Continental began supplying Pick N Pay had an adverse effect on all branded bread sales (5607–08). However, Signore testified that Continental's private label agreement with Pick N Pay did not have any effect on the retail pricing of bread in the Cleveland market (10025). On August 6, 1974, Vance of Continental reported that the bakery manager of Fisher-Fazio blamed Continental for the low bread prices in Cleveland because it had not "forced the price up to Pick N Pay." As punishment Fisher-Fazio cut Wonder's shelf space in its stores in half (CX 828).

341. On January 8, 1974, Laub ceased its bakery operations (5610–11 Stonbraker). Upon Laub's exit from the restaurant market, Nickels began an aggressive effort to obtain a substantial portion of the restaurant business in the Cleveland market (9355–56 Gase). Schwebel also entered the Cleveland restaurant market at the request of some of its customers (5808–16 Schwebel; 9356 Gase). Nickels gained some grocery business in the Cleveland market (9356 Gase). Both Nickels and Schwebel have increased their plant capacity in the last decade (9354–57 Gase).

342. In 1980 the ranking of the wholesale bakers in the Cleveland marketing area in sales to grocery stores was Millbrook, Continental,

Ward, Nickels, Schwebel and American. Including captive bakers, Fisher-Fazio had a third place ranking behind Millbrook and Continental (9354 Gase). A&P no longer has a captive bakery and has almost withdrawn from the Cleveland market, and Kroger sold captive bread to only six stores that do not do business under the Kroger name (9354, 9372 Gase). Millbrook and Continental are now considered to be the "price leaders" in the Cleveland market (9446–47 Gase).

343. In sales to the restaurant trade, Nickels is the first ranked wholesale baker followed by Millbrook, with Schwebel, [74] Continental and Ward sharing the balance about equally (9354 Gase). Continental's share of the restaurant market has not grown since 1971 (9355, 9383 Gase).

344. Continental's total sale of white bread in Cleveland has declined slightly since 1974, with branded sales declining and private label sales increasing (9371 Gase). In the last two years, Continental has increased its promotion of its Wonder branded bread (9372).

345. Although the wholesale prices of private label white bread and branded bread have increased since 1974, the spread between them has also increased (9373 Gase).

346. Continental closed its Youngstown plant in 1976, and transferred the Youngstown production to its Columbus and Toledo bakeries (9377 Gase). The Akron bakery, which is now a conventional mix plant, has not been profitable since 1972 (9401 Gase).

347. It is found that Continental discriminated in price between Pick N Pay on private label white bread and all of its other customers located in Northeastern Ohio and Pennsylvania. The lower discriminatory prices to Pick N Pay were below Continental's fully allocated costs at all times between July 1973 and September 1974 and when the proof of performance payments are taken into consideration, it appears that these low prices to Pick N Pay were below Continental's incremental costs and its average variable costs.

348. It is found that Continental knew or should have known that no other wholesale baker had offered Pick N Pay as low prices as did Continental on the private label products.

349. As a result of Continental's discriminatory pricing, as well as certain pricing practices designed to capture restaurant and institutional customers, competition between Continental and other wholesale bakers has been substantially and unfairly injured. In addition, concentration in the wholesale baking of white bread has increased since 1970.

350. Complaint counsel also challenge Continental's price discriminations from July 1973 through 1974 on purchases by Pick N Pay of private label products and purchases by Valu King, of private label, controlled label, advertised label and secondary label products (*See*

CX 2102 Stip.). Complaint counsel contend that such discriminations had the adverse effects upon competition between these unfavored purchasers and Pick N Pay prescribed by Section 2(a) of the Robinson-Patman Act, as amended.

351. There is no question but that Continental discriminated in price as alleged and that the discriminations were substantial (*See* Set 3 Adms. 36–60). [75]

352. Stop N Shop is a voluntary association of Cleveland supermarket owners who purchase and advertise collectively in order to compete effectively with the major chain stores (5493 Caster). During 1973 and 1974, the 20 Stop N Shop supermarkets were supplied in bread products by Millbrook, Continental, Laub and in a few stores, Ward (5495 Caster). It purchased approximately $4,000 worth of Wonder products per week and paid the wholesale price less 5% (5496–98 Caster; *see* CX 846). It also purchased private label bread from Millbrook and private label buns, hot dog and hamburger, from Continental (5498 Caster; CX 959). Although its sales of private label bread were greater than either Millbrook or Wonder advertised labels, sales of these advertised labels combined was greater than sales of private label (5503–04 Caster).

353. The list price to Stop N Shop for Continental's private label products were as follows (CX 912):

	before 7/25/73	7/25/73	8/18/73	1/14/74	2/25/74
8 Pk Ham	.203	.228	.265	.272	.30
8 Pk Dog	.203	.228	.265	.272	.30

354. Sometime between 1970 and 1973, Continental offered Stop N Shop private label bread at 17¢ to 17.5¢ per 1 lb. loaf. Although Caster would have recommended private label from Continental at the price which it charged Pick N Pay in 1973, he doubted whether the store owners would have accepted store door delivery service (5500, 5505 Caster; *see* CX 803).

355. In 1973 and 1974, Stop N Shop was able to "answer and compete" with any advertised price by Pick N Pay (5501, 5506 Caster).

356. BiRite Advertising Association was a group of approximately 30 independent supermarkets in greater Cleveland (5508 Rubin). BiRite carried the advertised labels of Millbrook, Wonder and Laub and also carried Bond's while it was still doing business in Cleveland (5509–10 Rubin). BiRite purchased all the white bread loaf sizes and 8 pack buns from Continental (5509–10 Rubin) and paid list price less a 5% discount (5509–11 Rubin). Its purchases from Continental were between $3000 and $5000 per week (5510 Rubin).

357. In 1973 and 1974, BiRite purchased private label bread and

buns from Millbrook. It paid approximately 18¢ for the 1 lb. loaf (5512, 5516 Rubin). Rubin did not believe he had ever received a better offer from Continental (5513). He testified that if he had been offered the same prices as afforded Pick N Pay in 1973, he would have tried to arrange for BiRite to "work with the program" (5514). BiRite's retail prices on bread were identical to the retail prices of Pick N Pay and Fisher-Fazio (5516 Rubin). Rubin thought BiRite was not able to buy on the same basis as some of his competitors (5519). **[76]**

358. In the 1970 to 1974 period, A&P's Cleveland division had 100 stores, approximately 30 of which were located in the greater Cleveland area (5845 Reed). Most of A&P's bread products were captive label; only 16% of the bread rack was open to the wholesale bakers (5851 Reed). Continental, Ward, Laub, Millbrook, Schwebel, Keystone and Nickel supplied various A&P stores in certain areas of the Cleveland division (5833 Reed). All of A&P's bread suppliers, including Continental, offered a 5% discount (5835 Reed). The A&P stores in the Cleveland Division purchased a total of between $4000 and $5000 per week from Continental (5840 Reed).

359. Between 1968 and early 1970, A&P requested bids from wholesale bakers for private label (5842 Reed). Continental's offer was not as low as the prices which it charged Pick N Pay in 1973 (5843 Reed; *see* CX 803A). A&P did not start a private label program at that time.

360. In 1974, Valu King Supermarkets was a voluntary group representing approximately 40 supermarkets located in a 60 mile radius of Youngstown (CX 992G; 5819 Tamarkin; 5256 Shreck). Continental sold a full line of Wonder bread and bun products to Valu King, the 18 oz. Wonder Loaf being one of the most popular white bread products (5820 Tamarkin). Continental provided full rack service to Valu King (5822 Tamarkin). Most Valu King stores paid list price less 7% discount of purchase of Wonder products (5823 Tamarkin). Other suppliers including Schwebel, Valu King's major supplier, granted 7%, except Keystone which offered 5% (5824 Tamarkin). Schwebel supplied Valu King with private label bread (5829–30 Tamarkin). Continental never offered Valu King private label bread at the prices afforded Pick N Pay in 1973 (5828 Tamarkin; CX 803). Mr. Tamarkin testified that bread was one of the most price sensitive items in the grocery industry (5829). Valu King did not compete with Pick N Pay (5828–29 Tamarkin).

361. In the early 1970's Kroger had 60 stores served by Continental's Akron plant, some of which were located in the Cleveland market (*See* CX 914A).

362. Open Pantry had 42 stores served by Continental's Akron plant and was one of Continental's private label customers (*See* CX 900, 914B; Set 3 Adm. 56–58; 9366, 9503, 9507–08 Gase).

363. It is found that Continental's lower discriminatory prices such as those granted to Pick N Pay on its private label products may have had the effects on competition between competing grocers that is proscribed by the statute.

DISCUSSION

Prior Proceedings

Although this initial decision is based solely on the administrative record in Docket 9000, references are made by **[77]** complaint counsel and respondents to a series of administrative and court proceedings involving Continental and the Federal Trade Commission relating to antitrust matters. These proceedings may be summarized as follows:

On May 11, 1962, the Commission issued an order pursuant to a consent agreement requiring Continental to divest itself of one bakery that it had acquired in 1958, and barring for 10 years Continental's further acquisition of an interest in any bread producer, unless permitted by the Commission. *Continental Baking Co.,* 60 F.T.C. 1134 (1962).

On December 31, 1963, the Commission dismissed a complaint against Continental that was issued in October 1959, charging violations of Sections 2(a) and 2(d) of the Clayton Act, as amended by the Robinson-Patman Act, on the grounds that Continental had proved that the challenged discriminatory prices had in each instance been granted in good faith to meet the equally low price of a competitor within the meaning of Section 2(b) of the statute. *Continental Baking Co.,* 63 F.T.C. 2071, 2162 (1963).

On February 28, 1964, the Commission issued an order prohibiting Continental and others from engaging in price fixing activities, as found to have taken place in the Seattle marketing area. *Bakers of Washington, Inc.,* 64 F.T.C. 1079, 1099 (1964), *aff'd sub nom., Safeway Stores, Inc.* v. *Federal Trade Commission,* 366 F.2d 795 (9th Cir. 1966), *cert. denied,* 86 U.S. 932 (1967).

On September 24, 1973, the United States Court of Appeals for the Tenth Circuit affirmed a District Court ruling that Continental had violated the terms of the 1962 consent order by acquiring an interest in two bread producers. This suit was a civil penalty action filed by the Department of Justice on the Commission's behalf. *United States* v. *ITT Continental Baking Co.,* 485 F.2d 16 (10th. Cir. 1973), *reversed on the question of the amount of penalties, United States* v. *ITT Continental Baking Co.,* 420 U.S. 223 (1975).

On December 12, 1973, the Commission issued an order to show cause why the 1962 consent order barring Continental's acquisition of any interest in bread producers should not be extended for a five year period. On November 26, 1974, the Commission rejected an Administrative Law Judge's recommendation that the 1962 consent order be extended for a 5 year period and dismissed the order to show cause. *ITT Continental Baking Co.,* 84 F.T.C. 1349, 1400 (1974). On that same day, November 26, 1974, the Commission issued the complaint in this proceeding, Docket 9000.

This Proceeding

Interpreting the complaint in this case in light of certain statements contained in the Commission's decision **[78]** dismissing the order to show cause, respondents contend that complaint counsel have made no serious effort to support the broad charges in the complaint to the effect that exits of wholesale bakers from the baking industry have been the result of ITT forcing Continental to behave in a predatory manner, that respondents plan to achieve dominance in wholesale baking in all relevant geographic markets, and that respondents, since 1952, have operated with the intent to lessen, hinder or restrain competition and to attain monopolies in wholesale baking (RBr. 2).

In respondents' view, complaint counsel have abandoned the complaint's broad charges of a nationwide program of predation and instead have "adopted the theories, contentions, and proof developed by lawyers in private litigation" involving six marketing areas. Respondents contend that "[t]rivial disputes over technical lawfulness of isolated transactions simply cannot sustain the basic charge made in the complaint that respondents have been predatorily attempting to take over the whole bread business throughout the nation" (RBr. 4–5).

Respondents contend that, at this stage of the administrative proceeding in Docket 9000, it is apparent that the broad allegations of the complaint have no factual or legal support and that such allegations are based upon a fundamental misapprehension of the nature of the competition faced by wholesale bread companies such as Continental (RBr. at 1).

I do not think that complaint counsel's approach to the issues raised by the complaint is as limited as respondents appear to argue. Although the primary emphasis is placed on respondents' practices and the effects of such practices upon competition in six marketing areas, complaint counsel have presented some evidence about Continental's bakeries in other marketing areas. However, in its 1974 decision dismissing the order to show cause, the Commission stated that it would not infer a lessening of competition in local marketing areas from trends in concentration at a national level, especially where there is admittedly no national geographic market. The Commission also pointed out that, although the exit of bakers from any market and the resulting increased concentration might be due to changes in technology and the industry members' adjustments thereto, it was the Commission's responsibility to "make very sure indeed that the larger members of the industry are not using any of the techniques prohibited by the antitrust laws to achieve a still *higher* level of concentration". The Commission added that the "critical issue of competitive injury must be resolved on the basis of changes in the structure of actual rather than hypothetical markets." (84 F.T.C. at 1396, 1399; Commission's emphasis).

In my opinion, the instant proceeding is consistent with the Commission's concern about the changing structure of the bread industry in local marketing areas. [79]

Price Discriminations

Section 2(a) of the Clayton Act, as amended by the Robinson-Patman Act, provides in pertinent part:

> It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, *** and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them.

Complaint counsel claim that, in the five separate marketing areas of Denver, Minneapolis-St. Paul, Southern California, Northern California, and Northwest Ohio, Continental has discriminated in price between purchasers of its white bread products and that such price discriminations have had the effects proscribed by the statue on competition between Continental and other wholesale bakers in the respective markets, and constitute primary line violations of the statute.

Respondents contend (RBr. 40–44) that complaint counsel have not demonstrated that the challenged pricing practices were predatory, have not demonstrated that the alleged injury was the result of price differences in commerce, have not demonstrated that the lower prices were subsidized by higher prices, or that the intensity of competition has actually been diminished in any of the markets involved (*See* R Reply Br. 49–51). Respondents contend that the Robinson-Patman Act must be construed to protect competition, not competitors, and that the exit of a handful of marginal bakers, the diversion of business from one seller to another or the lessening of profits is not sufficient to establish the injury element of a *prima facie* case (RBr. 43–44).

Respondents also contend that the Commission's price discrimination charge is "completely out of line" with more recent Commission enforcement of the Robinson-Patman Act (RBr. 40, n.1).

Section 2(a) prohibits price discriminations when the effect "may be substantially to lessen competition *** or to injure, destroy or prevent competition or tend to create to a monopoly in any line of commerce." It has long been considered that the statute seeks "to reach such discriminations 'in their incipiency' before the injury to competition is effected." *Corn Products Refining Co.* v. *Federal Trade Commission,* 324 U.S. 726, 738 (1945). The prohibition of the statute goes to the price discrimination itself and the probable result of the price [80] discrimination if it is not stopped or prohibited. Each case, therefore, must be adjudicated on its own merits, and, generalizations taken from previous cases are not necessarily controlling.

Commerce

In my opinion, complaint counsel have met the jurisdictional requirements of the statute. Admittedly, Continental is engaged in commerce. In each market area considered, Continental's local plant made sales of Wonder advertised label white bread at the higher price across state lines. Accordingly, the holding in *Gulf Oil Corp.* v. *Copp Paving Co.,* 419 U.S. 186, 200 (1974), relied upon by respondents, is not applicable here. The Denver plant sold Wonder advertised label bread in Wyoming, the Minneapolis and Rochester, Minnesota, plants sold Wonder advertised label bread in Wisconsin, bread baked by the Beverly Hills and DiCarlo plants in Southern California was sold in Arizona, the San Francisco, Oakland and Sacramento, California, plants sold Wonder advertised label bread in Nevada, and the Akron and Youngstown, Ohio, plants sold Wonder advertised label bread in Pennsylvania.

Actually all of Continental's sales which are the subject of this proceeding are in commerce. Notwithstanding the local nature of each of Continental's bakery operations, each grocery store purchaser is doing business with a corporation located in New York. Not only does Continental's headquarters engage in purchasing ingredients and supplies for the local bakeries, but its personnel engage in sales negotiations on behalf of local bakeries. It also finances the operations of each bakery, and creates and places the national advertising which makes possible the higher wholesale and retail prices for Wonder advertised label bread. *See Holland Furnace Co.* v. *Federal Trade Commission,* 269 F.2d 203 (7th Cir. 1959), *cert. denied,* 361 U.S. 932 (1960).

Lower Price is Subsidized

In this respect, the higher price for Wonder advertised label bread clearly subsidizes the lower prices for private label and secondary label whatever the pecularities of any individual market may be. In my opinion, the effects of a price discrimination on competition may be measured by the effects of the lower price on competition as well as the effects of the amount of the discrimination itself. This is especially true where the lower prices are below the seller's fully allocated costs.

Like Grade and Quality

It is undisputed that bread products are commodities of like grade and quality, *i.e.*, that Continental's advertised label white bread is the same bread product as its private label [81] or secondary label white bread. It is also undisputed that competing wholesale bakers' white bread is the same product as Continental's white bread, whether wrapped in advertised, private or secondary label. The only significant difference is the loaf size. In this respect, wholesale bakers almost invariably sell a line of products to their grocery customers, which may include a mix of white bread sizes and shapes.

Products

Continental claims that wholesale bakers and grocers do not negotiate for private label bread products on the basis of one product, but rather on the basis of all private label items as well as advertised label products. In this respect, they challenge any Robinson-Patman analysis that concentrates on one item for purposes of determining the amount of the price discrimination or the effect of the price discrimination.

One of the peculiarities of the bread industry is that certain loaf sizes of white bread are the high volume products. Although the most popular loaf size varies from market to market, grocers concentrate in marketing the popular sized loaf. In these circumstances, wholesale bakers and grocers negotiate on the basis of the price of the largest selling item. In addition, the wholesale baker considers the length of a production run that will be involved in producing the most popular item. In my opinion, it is proper to determine the amount of discrimination and its effect on competition by looking to the prices of the one bread product that dominates the market. *See Kroger Co.* v. *Federal Trade Commission,* 438 F.2d 1372 (6th Cir. 1971), *cert. denied,* 404 U.S. 871.

Predatory Pricing—Injury to Competition (Primary Line)

I agree with the parties that the principal issue in determining whether Continental's price discriminations are unlawful as charged, is whether Continental's conduct was predatory. Predation is now considered to be a crucial element in primary line discrimination cases, although the Commission has indicated that market analysis may be sufficient in a particular case to raise the probability of injury to competition, proscribed by the statute. *See Beatrice Foods Co.* 76 F.T.C. 719, 799 (1969), *aff'd sub nom. Kroger Co.* v. *Federal Trade Commission*, 438 F.2d 1372 (6th Cir. 1971), *cert. denied*, 871.

In the circumstances of each of the five market areas considered for Robinson-Patman enforcement in this case, it is clear that Continental knew or should have known that the consequences of its price discriminations would be to eliminate one or more of its competitors or substantially to injure competition and would result in further concentration in the wholesale baking industry. In most instances Continental knew that the lower discriminatory prices were below its fully allocated costs and below its competitors' fully allocated [82] costs. Moreover, in certain situations Continental knew or should have known that the prices of certain products were below its average variable costs. *See Utah Pie Co.* v. *Continental Baking Co.*, 386 U.S. 685, 698–700 (1967).

In Denver, through the Tender Crust program with Associated Grocers which granted a lower price on private label bread, Continental secured a substantial portion of the shelf space available to the wholesale bakers. The expected pricing reactions of competing wholesale bakers resulted in greater price discriminations and in Continental's sale of private label products well below its fully allocated costs. Continental knew or should have known that its lower prices were also below its wholesale baker competitors' fully allocated costs. At one time price discriminations were as great as 18% of the wholesale price of Continental's advertised Wonder loaf. Continental knew or should have known that Old Homestead would not be able to successfully compete under these conditions. In fact, Old Homestead ceased doing business as a wholesale baker shortly after the 18% discriminatory price was established by Continental. In the circumstances, such price discriminations are predatory in nature and their effects may be to (and actually did) substantially lessen competition between wholesale bakers.

In the TCTA, Continental reduced its price of Wonder advertised label by 8¢ a loaf when it established a wholesale price of 20¢ while maintaining a 28¢ wholesale price in Rochester, Minnesota. The 20¢ wholesale price on Wonder advertised label was below Continental's fully allocated costs. Continental's express purpose in initiating this price discrimination was to regain its volume of sales of advertised label bread with the expectation that retail prices of private label and captive label bread would thereafter be increased. Such a price increase would reduce the retail price spread between advertised label and private label bread and permit a price increase of advertised label bread *without* a loss in sales. However, the low retail prices of private label and secondary label bread, in turn, were due, in part, to Continental's low discriminatory prices to its private label customers and purchasers of its secondary label bread.

Continental knew or should have known that its low discriminatory price on advertised label bread would seriously reduce the profitability of its wholesale competitors by lowering the wholesale prices of advertised bread below its wholesale competitors' fully allocated costs or by substantially reducing its competitors' volume of secondary and private label sales. Continental knew that most of Zinsmaster's sales were advertised label bread, whereas most of Pan O Gold and Creamy Crust's sales were private label and secondary label bread. Continental also knew or should have known that the independent wholesale baker competitors would not be able to continue competing in the TCTA at such low wholesale price levels. Such price discriminations are predatory in nature and [83] their effects may be to substantially lessen competition between wholesale bakers.

In the Los Angeles (Southern California) market, Continental discriminated in price between purchasers of its Wonder advertised label and purchasers of its private label and secondary label bread. During the latter part of the 1960's and early 1970, the lower discriminatory prices in the Ventura area were below Continental's fully allocated costs and below Prosser's fully alloted costs. Continental knew that Prosser was a weak competitor and knew that Prosser could not survive if it was required to sell at such low wholesale prices. In fact, Prosser withdrew from the wholesale baking business in 1971.

In late 1971 and 1972, Continental sold private label bread in the Los Angeles area at low, discriminatory prices that were below Continental's fully allocated costs. With these low discriminatory prices, Continental obtained many new private label customers and foreclosed much available shelf space from competing wholesale bakers, including Gordon and American. It also offered the lower discriminatory prices to Gordon's only private label customer, requiring Gordon to lower its wholesale price below its fully allocated costs to retain that customer. Continental knew that Gordon and American were weak competitors and would not be able to compete at wholesale price levels below fully allocated costs. In fact, in 1974, Gordon withdrew from the wholesale baking industry, leasing its bakery to the Associated Grocers Cooperative, which thereafter produced its own private label bread for its member grocers. Also in 1974, American discontinued selling to grocery stores and concentrated its efforts on sales to restaurant customers.

Continental's price discriminations are predatory in nature and their effects may be to (and in fact did) substantially lessen competition between wholesale bakers.

In Northern California in 1972 Continental offered a 17.2¢ wholesale price on private label bread which was substantially lower than the wholesale price on its Wonder advertised label. This lower price was below Continental's fully allocated costs. Continental knew that Inglis, which had filed a bankruptcy petition in 1969 and which it considered to be a weak competitor, would not be able to compete effectively at such low wholesale price levels. Such a price discrimination is predatory in nature and its effect may be to (and in fact did) substantially lessen competition between wholesale bakers.

In the Cleveland area, Continental discriminated in price between purchasers of its Wonder advertised label and Pick N Pay on its purchases of private label bread. During the last half of 1973 and during most of 1974, the wholesale prices on Pick N Pay private label products were below Continental's fully allocated costs and close to, if not below, Continental's average variable costs. Continental knew or should have known that its weaker wholesale baker competitors in [84] the Cleveland marketing area would not be able to compete in a market of low retail bread prices which were a result of Continental's low discriminatory prices to Pick N Pay. Such price discrimination is predatory in nature and its effect may be to (and actually did) substantially injure competition between wholesale bakers.

Good Faith Defense

The Robinson-Patman Act permits certain price discriminations notwithstanding their proscribed effect. Section 2(b) provides:

> That nothing herein contained shall prevent a seller rebutting the prima facie case thus made by showing that his lower price *** to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor.

The "good faith" requirement of Section 2(b) has been interpreted as meaning that the grantor of the lower discriminatory price must "show the existence of facts which would lead a reasonable and prudent person to believe that the granting of a lower price would in fact meet the equally low price of a competitor." *Federal Trade Commission* v. *A. E. Staley Manufacturing Co.,* 324 U.S. 746, 759–60 (1945).

Respondents argue that in every instance where they granted a lower discriminatory price in the five marketing areas under consideration for Robinson-Patman enforcement, Continental believed that it was meeting the equally low price of a competitor. However, on the basis of the record in this proceeding, Continental has not made out its meeting competition defense.

In Denver, the agreement to sell Tender Crust at a wholesale price at least 1¢ below the wholesale price of Wonder advertised label bread was to be afforded without regard to a specific competitive offer. Subsequent pricing under modifications of the original Tender Crust agreement always established a wholesale price on Tender Crust below the wholesale price of competing wholesale bakers. Such conduct does not meet the requirements of Section 2(b).

In the TCTA, Continental's lower discriminatory price on its Wonder advertised label bread was not intended to meet any offer of a competing wholesaler to any of Continental's grocer customers. Moreover, the discriminatory prices given to its private label customers on private label bread were to meet Continental's customers' competition with captive bakers. These situations do not meet the requirements of Section 2(b).

In Southern California, the record is not clear which wholesale baker initiated the lower prices on advertised label [85] bread in the Ventura area in the late 1960's or whether such prices were discriminatory. It appears that Continental, Interstate and American matched each other's lower prices. However, it appears that Continental granted lower discriminatory prices on its secondary label in the Ventura area without regard to its wholesale baker competitors' prices. In addition, such prices were below Continental's fully allocated costs as well as below Prosser's wholesale price and fully allocated costs. The record is clear, however, that Continental's lower discriminatory price to Hughes on the largest volume loaf size of private label bread was below Interstate's offer. The requirements of Section 2(b) were not met.

In Northern California, Continental offered a 17.2¢ wholesale price on private label bread to all chain stores throughout the marketing area. The only other 17.2¢ price offered on a comparable product were on sales of private label bread by other wholesaler bakers to grocers in a few local areas. The 17.2¢ price was below Continental's fully allocated cost. Accordingly, Continental was knowingly undercutting the price of its competitors to many individual grocery stores and did not meet the requirements of Section 2(b).

Finally, in Cleveland, Continental's contract with Pick N Pay in 1973, and as renegotiated in 1974, set wholesale prices of private label products that were below Continental's fully allocated costs and which were below any competitive offer. Continental knew or should have known that it was not meeting any competitors' price offer and, accordingly, the requirements of Section 2(b) were not met.

There have been many other interpretations of the "good faith" element of Section 2(b), other than the question of whether the seller acted reasonably in determining the actual amount of the competitive offer he was allegedly meeting. For example, it has been held that 2(b) applies only to individual price concessions and not to systematic or generalized price discriminations. *Federal Trade Commission* v. *Cement Institute* 333 U.S. 683 91948); *Federal Trade Commission* v. *A. E. Staley Manufacturing Co.,* 324 U.S. 746 (1945); *Federal Trade Commission* v. *Standard Oil Co.,* 355 U.S. 396 (1958). There is a question as to whether 2(b) is applicable where the discriminations are used aggressively to obtain new business or more business, instead of protecting one's business with a customer. *Standard Oil Co.* v. *Federal Trade Commission,* 340 U.S. 231, 249–50 (1951); *Great A&P Co.* v. *Federal Trade Commission* 440 U.S. 69 (1979); *Standard Motor Products, Inc.* v. *Federal Trade Commission,* 265 F.2d 674 (2d Cir. 1959). And it should seriously be considered whether discriminatory sales below cost to obtain new business could ever be considered a good faith meeting of the equally low price of a competitor. *See Sunshine Biscuits,* 59 F.T.C. 674, 678 at 679–81 (1961), *rev'd,* 306 F.2d 48 (7th Cir. 1962). In my opinion, Continental also has failed to meet the requirements of Section **[86]** 2(b) for one or more of these other reasons in each of the five marketing areas in which it granted the challenged price discriminations.

Respondents contend that the good faith meeting of competition defense has already been adjudicated in their favor, citing the Commission dismissal of the Section 2(a) price discrimination matter in 1963. *Continental Baking Co.,* 63 F.T.C. 2071 (RBr. 47). It appears that the evidence in that proceeding concerned specific discounts granted from Continental's list prices to 20 retail grocery customers. All but two of those customers were shown to have been, at the time the discounts were granted and thereafter throughout the period covered by that case, receiving at least as high discounts from one or more of Continental's competitors. The other two grocery customers had been offered, and had available to them, discounts from Continental's competitors at least as high as those granted by Continental. The circumstances in the instant case under which the lower discriminatory prices were granted are markedly different than the circumstances involved in the prior proceeding. Not only has Continental not met the basic requirements of the statute in the instant case, but Continental has also failed to demonstrate compliance with its own policies on meeting competition, because competitive offers were not documented with respect to the private label arrangements in most instances.

Cost Justification Defense

Respondents contend that the Wonder-Tender Crust price difference in the Denver marketing area was cost justified (RPF 168–169). They rely upon a study prepared by Lloyd Swan for use in the *Old Homestead* trial in 1971 (RPF 169; CXs 1722 Swan; 1728). The comparison made by respondents for cost justification purposes is between the profits Continental ostensibly made on Wonder advertised label bread and Tender Crust private label bread. There is no dispute that Mr. Swan calculated hypothetical costs applying percentages to the list prices in effect during relevant periods. It is doubtful whether such allocations of costs are adequate for purposes of cost comparisons. Continental did not keep records in those days from which it could calculate the actual costs of producing and selling any single variety of bread product.

Moreover, the price differences shown on the Forms 452B were usually one cent. The actual price differences shown on this record during the last quarter of 1966 through December 1967 ranged between 2.2 and 3.6¢. In many instances, the difference in profit between Wonder advertised label bread and Tender Crust private label bread were not as great as the price difference between them. In my opinion, respondents have not carried their burden to demonstrate a cost justification defense. They do not appear to assert such a defense for any other price discrimination challenged in this proceeding. [87]

Competition

One of respondents' defenses to the "primary line" Robinson-Patman allegations is that the competing wholesale bakers that withdrew from the baking business during or shortly after Continental engaged in the challenged price discriminations were marginal firms who were not advertising their products, who were mismanaged, inefficient, under capitalized, and doomed to failure irrespective of what Continental did (*See* RBr. 43). In effect, Continental is contending that its pricing actions, considered necessary for its own survival, are not illegal because they happened to hasten the departure of competitors. Realistically, however, the survival in a local market of a company operating a large number of bakeries in many markets at the expense of the early withdrawal of a local bakery is exactly the type of situation the Robinson-Patman Act was intended to prevent. The resulting concentration of market power is the indicia of a lessening of competition and the type of competitive injury with which the statute is concerned.

Respondents also contend that the degree of effective competition in each of the markets has not diminished over the years and that, accordingly, enforcement of the Robinson-Patman Act is not in the public interest. But, as stated before, the Robinson-Patman Act was to prevent those price discriminations in their incipiency that may be to substantially lessen competition. It is found that respondents' price discriminations are such that, if permitted to continue, or if resumed or pursued in other markets, may have the effect of lessening competition between wholesale bakers. The record in this case is clear that effective competition between wholesalers in the five markets substantially was diminished over time.

Enforcement Policy

I do not agree that the Commission's lack of Robinson-Patman enforcement against sellers since the *Kroger-Beatrice* decision in 1969 reflects a Commission judgment as to the lack of public interest in such enforcement. The complaint issued by the Commission in Docket 9000 contained a Robinson-Patman price discrimination charge. It was complaint counsel's duty to pursue that matter should the facts and circumstances warrant, and it is the duty of the Administrative Law Judge to adjudicate the issues presented. It is a grave mistake for any businessman to believe that the Commission's temporary inaction grants him a license to disregard the prohibitions of statutes such as the Robinson-Patman Act.

Price Discriminations—Injury to Competition (Secondary Line)

It is well settled that substantial price discriminations on products sold to competing grocery store customers may be to substantially injure competition between them. *See United Biscuit Co. of America* v. *Federal Trade* [88] *Commission*, 350 F.2d 615 (7th Cir. 1965), *cert. denied*, 383 U.S. 926; *Federal Trade Commission* v. *Morton Salt Co.*, 334 U.S. 37 (1948); *Foremost Dairies Inc.* v. *Federal Trade Commission*, 348 F.2d 674 (5th Cir. 1965), *cert. denied*, 382 U.S. 959. It has also been held that where a price differential between an advertised brand and private label brand reflects no more than the consumers' preference for the advertised brand, such price discrimination does not create the injury prescribed by the statute. *See Bordon Company* v. *Federal Trade Commission*, 381 F.2d 175 (5th Cir. 1967). In the instant case, the price discriminations arising from the private label prices afforded Pick N Pay in Cleveland and the chain stores in the Reno area appear to be more than a difference which merely reflected consumer preference between advertised label and private label bread. It is found that Continental's pricing practices in Cleveland and Reno constituted secondary line injury violations of the statute.

For reasons already stated, respondents' lower discriminatory prices in the Cleveland market area and in the Reno portion of the Northern California area were not granted in good faith to meet the equally low prices of a competitor within the meaning of Section 2(b) of the Clayton Act, as amended.

Attempt to Monopolize

Section 5 of the Federal Trade Commission Act provides in pertinent part:

> Sec. 5(a)(1). Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful.
> Sec. 5(a)(2). The Commission is empowered and directed to prevent persons, partnerships, or corporations, *** from using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce.

It is well settled that Section 5 covers conduct that either violates the prohibitions of the Clayton Act and the Sherman Act or conduct that could lead to unreasonable restraints on competition if not prohibited. *See Federal Trade Commission* v. *Brown Shoe,* 384 U.S. 316, 321 (1966); *Federal Trade Commission* v. *Cement Institute,* 333 U.S. 683 (1948).

An illegal attempt to monopolize, constituting a violation of Section 2 of the Sherman Act, involves a "specific intent" to control prices or destroy competition in a relevant market, predatory or anticompetitive conduct directed to accomplish those ends, and a dangerous probability of success. *Purex Corp.* v. *Proctor & Gamble Co.,* 596 F.2d 881, 890 (9th Cir. 1979); *Janich Bros., Inc.* v. *American Distilling Co.,* 570 F.2d 848, 853 (9th Cir. 1977); *Golden Grain Macaroni Co.,* 78 F.T.C. 63, 164 (1971), *enforced in part,* 472 F.2d 882 (9th Cir. 1972), *cert. denied,* 412 U.S. 918 (1973). **[89]**

These criteria are not mutually exclusive but rather are interrelated. Evidence of conduct may shed light on intent and the probability of success. Evidence of a company's purpose may reveal whether the conduct is reasonably related to legitimate business needs. *See Janich Bros.,* 570 F.2d at 853; *Transamerican Computer Co.,* v. *IBM Corp.,* 481 F.Supp. 965, 989 (N.D. Cal. 1979).

With respect to the "dangerous probability" issue, there is conflict in the law as to what degree of market power, or proximity to monopoly status need be shown before a finding of liability can be made. *Compare Greyhound Computer Corp., Inc.* v. *IBM Corp.,* 559 F.2d 488, 496, 504 (9th Cir. 1977) *with United States* v. *Empire Gas Co.,* 537 F.2d 296, 305 (8th Cir. 1976), *cert. denied,* 429 U.S. 1112 (1977).

It is generally accepted that monopoly power exists when an industry member has the power to raise prices or exclude competition when it so desires, and that such monopoly power is unlawful if it is willfully maintained or acquired as distinguished from arising from growth or development as a consequence of superior product, business acumen or historical accident. *Purex Corp.* 596 F.2d at 890; *Golden Grain Macaroni Co.*, 78 F.T.C. at 157.

Contentions of the Parties

Complaint counsel contend that Continental's predatory pricing practices, including price discriminations and sales below cost, along with other instances of predatory conduct, demonstrate that Continental intends to destroy competition between wholesale bakers and intends to gain monopoly positions in local wholesale white bread markets. Complaint counsel argue that, absent some remedial action, Continental may be successful in gaining such monopoly positions (CC Br. 16–33).

Respondents contend that complaint counsel's attempt to establish a relevant market limited to white bread produced by wholesale bakers is not realistic (RBr. 22–27). They point out that captive bakers which produce an identical white bread product are a dominant competitive factor in the bread industry, especially in the six markets which are the subject of this case (RBr. 23–24). Respondents contend that the retail prices established by the captive bakers have a controlling effect on the wholesale bakers' wholesale price of advertised label and private label bread in that the captive label bread and wholesaler baked bread compete directly for the consumer dollar (*I.d.; See* R Reply Br. 60–61). Respondents also contend that white bread by itself is not a proper product market because other bread products are acceptable substitutes, as demonstrated by the fact that during the 1970's there has been a substantial decrease in the consumption of white bread whereas the consumption of variety breads has increased during the same period (*See* RBr. 26–27). [90]

Respondents argue that Continental's pricing practices were not predatory, but merely responded to the competition of the captive bakers. They contend that there is "chronic" excess capacity in the bread industry created by the growth of the captive bakers, as well as the decreased consumption of bread, and that the wholesale bakers' competition for the shrinking available shelf space has created chaotic conditions in certain markets in the bread industry (RBr. 5–6; *see* R Reply Br. 61–62). Respondents also contend that in such circumstances, to sell below fully allocated costs, but over "marginal" or "variable" costs, is a reasonable business decision, in that such sales contribute to a positive cash flow and to the overall profitability of the business (*See* RBr. 36–37).

Finally, Respondents claim that entry into the bread baking business is easy and, accordingly, there is no way that Continental could achieve a monopoly position in any bread market (RBr. 31, 33–35; *see* R Reply Br. 66–67). They argue that the wholesalers must respond to the grocers' demand for low cost private label bread or face the possibility that those grocers will become captive bakers (RBr. 10, 31).

Relevant Product Market

In my opinion, wholesale baked white bread has such distinctive product and market characteristics that it may be considered a relevant market or submarket upon which to determine the effects of Continental's challenged practices in the context of an alleged attempt to monopolize case. Quite clearly, concentration of the wholesale white bread business in the hands of one wholesale baker in a marketing area would constitute a monopoly. Any retail grocer which did not have its own bakery would have to buy white pan bread from one source. Moreover, retail grocers could not remain competitive by selling only bread products other than white pan bread.

Captive bakers do not compete in selling to grocery stores; they limit distribution through their own retail outlets. Wholesale bakers, on the other hand, compete with other wholesale bakers in the sale of bread products to grocers.

White pan bread is the most important bread product to the large wholesale baker. The quantities involved permit long production runs which maximize efficiencies and increase profitability. The record shows that many bakeries concentrate their production efforts in white pan bread and that the volumes of white bread produced and sold do, in fact, reflect the profitability and competitive strength of wholesale bakers. For example, Continental's Akron and Minneapolis bakeries appear to have been exclusive white bread bakeries.

These white bread products are also the most important bread products to the grocer. The largest and best shelf space **[91]** is allocated to these products. Most private label arrangements concentrate on white bread and negotiations are usually centered on determining the wholesale price of the most popular loaf size of white bread in a particular marketing area.

The fact that wholesale baked white bread is sold at retail by grocers in competition with captive label bread, either from the same bread table, or from the bread tables of competing grocers, does not place captive bakers in competition with wholesale bakers at the wholesale level of competition. Delineation of wholesale baked white bread as a relevant market conforms to the requirement that a relevant market be an area of effective competition and is consistent with the realities of competitive practice in the market place. *See L. G. Balfour Co.* v. *Federal Trade Commission*, 442 F.2d 1 (7th Cir. 1971).

No Chronic Excess Capacity

The record does not show that there was "chronic" excess capacity in the bread baking industry, during the relevant periods, at least not in the six market areas that are examined in this record. The practical production capacity of a bakery consists of two shifts and some overtime or approximately 80% of the maximum production possible. Capacity is not, as Continental suggests, measured by the maximum output possible. Bakers need reserve capacity to handle unusual demands that occur from time to time and from season to season.

The excess capacity that is indicated in this record existed where Continental built a new plant (Denver), was operating a plant at a little over one shift and sustaining a loss over a number of years (Akron), or was losing a large private label customer which built a captive bakery (Los Angeles). Accordingly, the competitive conditions in those markets seemed to have been generated by Continental's attempt to "fill" or "over fill" the optimum efficent capacity of its plants. The question here is whether Continental's aggressive price discriminations involving below cost pricing to take business from its competitors in order to fill its plants is really a response to excess capacity.

Barriers to Entry

The record does not demonstrate that it is easy to enter the wholesale bread baking industry. Although there are no technical barriers, there are certain market barriers, the most important of which is the creation of a consumer franchise. For unless a wholesale baker has an acceptable advertised label, it will not be able to obtain the necessary bread shelf position and space to fill a modern bakery. The record shows that practically no wholesale baker has entered a market in the 1970's except by acquisition of an existing baker. The only new entrants have been several large chain stores that have built their own captive bakeries. However, the record also shows that a number of large chain stores closed **[92]** their captive bakeries during the 1970's, and that the trend toward captive baking has abated.

Another barrier to entry into the wholesale baking business may be the propensity of the large multiplant companies to engage in below cost pricing in particular markets. Such parallel behavior was practiced in the Denver, Minneapolis, Los Angeles and San Francisco markets. The record shows that a local bakery cannot survive in such a competitive atmosphere. The margin of profit and the return on investment are not great enough to attract capital expenditures in such an unstable atmosphere as exists in the wholesale baking business.

Pricing Below Cost

In defense of its below cost pricing, Continental relies on a commentary by Areeda and Turner and certain court decisions that have adopted the view, that, if such pricing is above marginal or variable costs, pricing below fully allocated costs should not be presumed to be predatory (RBr. 35–36). In the context of this case, this proposition is not controlling. Such a view overlooks the fact that a large multiplant firm which prices products below fully allocated costs for an extended period of time in a local market either knows or should know that single plant firms in that local market may be irreparably injured or become so "conditioned" that they become "passive" competitors. This conditioning would be especially true in the wholesale bread business because no wholesaler can charge a higher wholesale price for white bread than the lowest wholesale price prevailing in the market for a comparable product without losing a substantial share of its white bread sales.

Continental contends that its pricing practices were reasonable responses to competitive conditions engendered by low retail prices established by captive bakers. It contends that the alternative to below cost pricing is withdrawal from the market (*See* R Reply Br. at 1). Continental's argument might be rephrased to mean that Continental should be free to engage in any conduct that will ensure to it a share of the market sufficient to permit Continental to operate at optimum efficiency. Approval of such a philosophy would negate the principal purpose of the antitrust laws, which is to prevent the restructuring of an industry to accommodate the most powerful member.

Continental also contends that the question of whether it sold its bread products below cost (whether below average variable cost or below fully allocated costs) should be determined on the basis of its costs of selling all products in its line to a particular grocery customer. In this respect, Continental points out that private label bread is sold with the expectation that the wholesale baker, by obtaining the next best position on the bread rack, will increase its sales of **[93]** advertised label bread. Continental suggests that it would never enter into a private label agreement unless it expected to make a profit on the total amount of business done with any customer.

The record shows that Continental does not control the "mix" of products purchased by the grocer. Many factors, including the retail price spread between private label and advertised label products, determine the relative quantities of each label sold. The grocer appears to negotiate private label prices separately and usually makes his decision to enter into a private label arrangement with the wholesale baker on the basis of the wholesale price of the most popular size loaf or loaves of white bread. Although Continental's contention as to measuring costs on the basis of an entire line might have some merit in a different industry setting, the peculiarities of the bread industry make such treatment inappropriate. The record shows that Continental continued selling private label to certain chain stores, although the amount of advertised label also sold could not possibly make the total sale profitable on a fully allocated cost basis.

Unreasonable Pricing Practices

In its recent *DuPont* decision, the Commission set forth criteria by which to measure whether a firm's competitive behavior is reasonable, notwithstanding the anticompetitive effects that might result from such behavior [Current Binder] 3 CCH Trade Reg. Rep. ¶ 21770 (1980) [96 F.T.C. 653]. Aside from the fact that Continental's pricing practices were illegal under Section 2(a) of the Robinson-Patman Act, its practices do not appear reasonable under the stated criteria. For example, below cost pricing cannot be considered to be an ordinary marketing practice and it is certainly not profitably or economically rational in itself. Such practices do not result in improved product performance and it is doubtful whether such below cost pricing would be effective in gaining and in holding market share for a firm which did not have substantial economic resources. In the market setting where the barriers of entry into wholesale baking are high, the anticompetitiveness of the challenged practices are exclusionary and disciplinary. In this respect, the effects of the practices are not reversible. In my opinion, Continental's behavior was not "reasonable" within the framework of a "rule of reason" test.

Price Leadership

Continental points out that it has no power to raise its prices without regard to its competitors' pricing, and that the absence of such power demonstrates that it has no monopoly power, and, in the circumstances of the bread industry, cannot obtain such power.

Although it cannot raise prices unilaterally, Continental is considered to be the price leader in many [**94**] marketing areas, in that, historically, the other wholesalers will usually follow Continental's lead in raising prices. It is not clear whether such leadership is the result of prolonged periods of low wholesale bread pricing, and the necessity to regain profitability, or an automatic response to Continental's moves in order to forestall any disciplinary action.

In my opinion, such price leadership demonstrates Continental's pricing power. In my opinion, Continental's predatory conduct is clearly "intended" to maintain or acquire such pricing power. The price leadership theme appears often in Continental's internal documents and appears to be the principal motivating force behind Continental's conduct challenged in this proceeding.

Alleged Threats

Complaint counsel contend that respondents' predatory intent is demonstrated by certain other actions taken by Continental's personnel against its wholesale baker competitors. For example, in the TCTA (Minneapolis), Continental's officials allegedly made threatening statements to Zinsmaster and Creamy Crust (CCPF 9–82; CC Mem. 97). In the Los Angeles marketing area, certain threats were allegedly made to the Gordons (CCPF 11–58; CC Mem. 122). These accounts are not supported by sufficient non-hearsay evidence to be considered as part of the pricing transactions that are challenged as predatory in nature. However, such events do indicate that some of Continental's wholesale baker competitors were apprehensive about Continental's possible actions in their marketing areas.

Market Strategy

One of complaint counsel's main contentions is that respondents have adopted a strategy of delaying wholesale price increases in order to hasten the exit of their weaker wholesale baker competitors. Complaint counsel cite this "hold-the-line-on-prices" strategy as the indicia of respondents' predatory intent.

Respondents claim that they never adopted such a strategy. They contend that the McKinsey report merely suggested a further study into the feasibility of such a strategy and they deny that Continental's officials ever discussed such a strategy.

The record shows that the effects of such a strategy were discussed among ITT, Continental and McKinsey personnel during the meetings that were part of the study conducted by McKinsey during 1971 (*See* CX 28S, T). Denial of this by respondents belies the management sophistication which is respondents' principal asset. Moreover, there can be no doubt that such pricing would be injurious to Continental's wholesale baker competitors. The record also shows that Continental did maintain low discriminatory, below cost prices on certain **[95]** products, usually on private label products, over relatively long periods of time in certain marketing areas.

It appears, however, that respondents adopted market strategies responsive to each individual market situation. Although their pricing moves were designed to take advantage of the weaknesses of their wholesale baker competitors, it cannot be concluded on this record that such decisions were part of some over-all "hold-the-line-on-prices" strategy. Nevertheless, the fact that respondents were aware of the result of their below cost pricing supplies the "predatory intent" necessary in an attempt to monopolize case.

Market Shares

Finally, Continental argues that in, the circumstances of the bread industry, there is no possibility that it could be successful in obtaining a monopoly in any local market. They point out that the evidence pertaining to the six geographic areas which were the subject of detailed analysis in this case demonstrate that it has not been able to obtain a leading share of any market, much less a monopolist's share in any of those markets.

In my opinion, Continental's actual success or failure of obtaining very high shares of the wholesale baking business in any of these six markets is not important. There is no doubt that Continental has improved substantially its position in the wholesale white bread market in several areas, namely, Denver, Los Angeles, Northern California, and Cleveland. In the latter three, Continental, for all intents and purposes, shares the entire wholesale produced white bread market with one of its multiplant wholesale baker competitors. In Los Angeles and Cleveland, it shares the wholesale baked bread market with Interstate and in Northern California it shares the market with Campbell-Taggart.

High concentration of market shares of the wholesale baked white bread market in a local area does not appear to be procompetitive in the bread industry. Wholesale bakers with established consumer franchises are able to sell advertised white bread at higher prices than other identical products. Maintaining such consumer franchise through advertising creates substantial barriers to entry into the wholesale white bread market because of the limited shelf space available. It is entirely possible that several wholesale bakers with a highly concentrated share of the white bread market can, through observance of price leadership and through control of the source of private label bread available to grocers, obtain higher prices for their white bread products, increase their sales of more profitable advertised label and variety breads, and thus make higher profits. It appears that Continental's strategy in certain markets in which they share the market about equally with another multistate wholesale baker was to emphasize sales of advertised label bread following the events challenged by [96] complaint counsel and the withdrawal of some of its smaller wholesale baker competitors from the market. The Northern and Southern California and Denver markets reflect Continental's reemphasis on the higher priced advertised label bread.

Moreover, Continental has been a defendant in private treble damage actions in each of these six markets and it may well be that as a result respondents' conduct since 1974 has been less aggressive in these areas. It should also be pointed out that respondents' production capacity available to service a particular market is limited. Although a multiplant firm such as Continental is more flexible because it can make certain interplant shipments, it does not appear that Continental has the production capacity to take more than a 50% share of any of the six market areas. In fact, with the exception of Pittsburgh and Washington, D.C., Continental's market share of any major wholesale white bread market does not appear to be more than 50% (*See* CX 4(131); *see also* CCPF 6-232).

In my opinion, Continental engaged in practices which contravened the general prohibition against attempting to monopolize. Such conduct violates Section 5 of the Federal Trade Commission Act.

If respondents are not prohibited from engaging in such predatory practices as selling below cost and discriminatory pricing and if the market power or potential market power they have obtained in certain markets is not controlled or reduced, the wholesale baking industry may continue to become more concentrated and less competitive.

ITT's Responsibility for Continental's Behavior

Respondent ITT is fully responsible for Continental's conduct which is the subject of this proceeding and which took place after the merger of ITT and Continental in 1968. It is not disputed that ITT had knowledge of, participated in and ratified Continental's management decisions and policies designed to assure that Continental would contribute its share to ITT's profits (*See* 626, 634-35 Woodward; 885-896 Stolle; CXs 113A, 25A-C; *see* CX 20). ITT benefited directly from Continental's business practices, and it should be named in any order issued in this proceeding. *See P.F. Collier & Son Corp.* v. *Federal Trade Commission*, 427 F.2d 261 (6th Cir. 1970), *cert. denied*, 400 U.S. 926.

CONCLUSIONS OF LAW

1. The Federal Trade Commission has jurisdiction over the subject matter of each of the counts of the complaint in this proceeding.

2. The Federal Trade Commission has jurisdiction of respondents. **[97]**

3. Respondent International Telephone & Telegraph Corp. is engaged in interstate commerce as "commerce" is defined in the Federal Trade Commission Act.

4. Respondent ITT Continental Baking Company, Inc., is engaged in the sale and shipment of bread in interstate commerce as "commerce" is defined in the Federal Trade Commission Act.

5. The baking, sale and distribution of white pan bread and bread

type rolls by wholesale bakers is an appropriate relevant product market in which to evaluate the conduct of respondent ITT Continental Baking Company, Inc.

6. The respondents' acts and practices as hereinabove found, hindered, lessened, eliminated, injured, destroyed or foreclosed actual and potential competition in wholesale baking and increased the probability that respondents will attain monopoly power in the wholesale baking industry in local geographic markets.

7. The respondents' acts and practices, as hereinabove found, are in violation of Section 5 of the Federal Trade Commission Act, as amended, and of Section 2(a) of the Clayton Act, as amended.

8. The proceeding is in the public interest.

Remedy

In the order filed with their proposed findings, complaint counsel seek provisions that: (1) would require the divestiture by respondents of five bakeries (Beverly Hills, Sacramento, Minneapolis, Akron, and Salt Lake City, Utah); (2) would require compulsory trademark licensing of respondents' trade names to these new wholesale bakers; (3) would prevent respondents from impairing the viability of the bakeries to be divested; (4) would reinstate the moratorium on acquisitions which expired in 1973; (5) would prohibit sales of bread products below cost; (6) would prohibit price discriminations in the sale of bread products; and (7) would require respondents to maintain certain records pertaining to its costs (*See* CC Mem. 174–181; CCPF 5–60–5–66).

Respondents contend that there is no record support for the proposed divestitures because the record in Docket 9000 does not detail the present competitive posture or financial condition of the five bakeries selected by complaint counsel for divestiture (R Reply Br. 68–72). Respondents argue that the proposed compulsory licensing makes no sense. They point out that Continental would be eliminated from any market in which it could not use its brand name (advertised label) because two bakers could not use the same brand name in any one market. Respondents also point out that the provision of the order that prohibits Continental from hiring personnel employed by the [98] bakeries selected for divestiture is unfair to the employees and would, in any event, eliminate Continental from the markets involved (R Reply Br. 70-71). Respondents also argue that the Commission does not have the authority to order divestiture in a case brought pursuant to Section 5 of the Federal Trade Commission Act which does not involve illegal acquisitions.

Respondents challenge complaint counsel's proposed ban on future acquisitions, noting that the record does not contain evidence of any illegal acquisition since the Commission, in 1973, refused to extend a 1962 order which prohibited such acquisitions.

Respondents argue that the provision of complaint counsel's order that prohibits Continental from selling any of its bread products below fully allocated costs is not only unprecedented but would put Continental out of business. For example, if a competitor established prices above its marginal costs but below Continental's fully allocated costs, the competitor would be able to take away Continental's business.

Respondents argue that the prohibition on price discrimination would eliminate their private and secondary label sales because such products would have to be priced at the same level as its advertised label. They also point out that the provision, as written, would not permit the use of the "meeting competition" or other statutory exceptions.

It is well settled that the Commission has wide discretion in its choice of a remedy adequate to cope with the unlawful practices in which respondents were found to be engaged. *Federal Trade Commission* v. *Ruberoid Co.,* 343 U.S. 470 (1952). That discretion will not be overturned by the reviewing courts unless the remedy has no reasonable relation to such practices. *Ruberoid Co.,* 343 U.S. at 473; *See Jacob Siegel Co.* v. *Federal Trade Commission,* 327 U.S. 608, 611–613 (1946).

In my opinion, the Commission has the authority to order divestiture to break up a monopoly or to restore competition that might have been lessened as a result of illegal conduct, even where no acquisition has been challenged. *See Federal Trade Commission* v. *Dean Foods Co.,* 384 U.S. 597, 606 n.4 (1966); *L.G. Balfour Co.* v. *Federal Trade Commission,* 422 F.2d 1, 23 (7th Cir. 1971); *International Boxing Club* v. *United States,* 358 U.S. 242 (1959). Otherwise, the Commission could not fulfil the Congressional mandate "to prevent . . . unfair methods of competition" in cases involving illegal monopolization or attempts to monopolize.

Notwithstanding the general rules concerning the Commission's discretion and authority in issuing orders, the provisions of any order must be realistic and the consequences of a respondent's compliance therewith must be compatible with the result the order is intended to accomplish. *See L. G.* [99] *Balfour* 442 F.2d at 23; *compare Colgate Palmolive Co.* v. *Federal Trade Commission,* 310 F.2d 89 (1st Cir. 1962) *with Federal Trade Commission* v. *Colgate Palmolive Co.,* 380 U.S. 374 (1965), *reversing Colgate Palmolive Co.* v. *Federal Trade Commission,* 326 F.2d 517 (1st Cir. 1963).

Respondents' objections to the divestiture provisions of the order raise serious questions as to whether the order will accomplish complaint counsel's purpose. As I understand complaint counsel's position, they intend to establish five independent single plant baking companies in order to restore effective competition in four local markets by reducing the level of concentration of market shares among wholesale bread bakers. In this respect, complaint counsel appear to envision that Continental will still be one of the wholesale baker competitors in each market; they point out that Continental will have at least one bakery in each market, *viz.;* DiCarlo in Southern California; San Francisco and Oakland in Northern California; Rochester in Southern Minnesota; Columbus and Dayton in Ohio; and Ogden in Utah.

I agree with complaint counsel that the viability of these new bakeries would depend on large part on each one having a strong consumer franchise. Compulsory licensing of Continental's established advertised brand name, Wonder, would accomplish this. But, on the basis of this record, respondents are correct in pointing out that grocers would not purchase the same brand product (Wonder) from two different wholesale bakers. And if Continental was successful in developing a consumer franchise for another brand, for example Home Pride, the newly created bakers could, under the provisions of the order, require Continental to grant them a license to use that brand name also.

It should be pointed out that the major wholesale baker competitors in four of the markets in which complaint counsel's newly created wholesale bakers will operate are multiplant corporations, Interstate in Los Angeles and Cleveland, American in Minneapolis, and Campbell-Taggart in Sacramento. The record indicates that Interstate and Campbell-Taggart also discriminated in price and sold bread products below their fully allocated costs. While it should not be presumed that any wholesaler will engage in illegal practices, the record facts do point out how vulnerable complaint counsel's newly created one-plant wholesale bakers will be to the competition of major multiplant competitors, who apparently will not be under conduct prohibitions such as those contained in the proposed order in this case. I am not certain that the newly created companies would be any more competitive than Inglis, Gordon, Prosser or Laub proved to be. In spite of the illegal practices in which respondents were found to be engaged Continental does provide competition that checks the market power of those other multiplant corporations with which Continental now shares a monopoly in these marketing areas. [100]

Although the legal and factual issues in this case turn on the importance of white pan bread to wholesale bakers, as well as to retail grocers and consumers, it is also clear that successful wholesale bakers sell a complete line of bread products, including variety breads and muffins. The record shows that during the relevant time periods during which the challenged practices took place, many of Continental's bakeries specialized in producing particular products. For example, the Minneapolis bakery produced mainly white bread and white bread buns and rolls, whereas the Rochester bakery produced mostly variety breads. The Akron bakery produced only white bread and was supplied with variety breads from other Continental bakeries in the Detroit region. Although the Beverly Hills bakery appears to have had the capability of producing both white pan bread and variety breads, it was supplied with buns and rolls and certain variety breads from the DiCarlo and the Salt Lake City bakeries. In my opinion, the viability of complaint counsel's newly created wholesale bakers must depend in large part on their capability of producing, or purchasing for resale at wholesale, a full line of bread products.

I agree with respondents that the record does not contain specific information about the current competitive posture or financial condition of the bakeries targeted for divestiture. One of complaint counsel's expert witnesses who recommended divestiture as a possible remedy in this case, agreed that the feasibility of any divestiture would depend upon a very extensive examination of the bakeries to be divested in terms of production, finance and economics (8083 Boyle). Although such a record difficiency could be remedied by reopening the record in this case, a greater problem exists. It can be anticipated that any divestiture that may be ordered by the Commission will not actually take place until the mid-1980's, because any such order will not have any force and effect until it becomes final, following Commission decision and court review. Moreover, during this period of time, respondents will not be subject to the ancillary prohibitions of the order relating to transferring personnel, holding separate the operation of the bakeries, and preserving the viability of the bakeries as such separate entities.

Although it is impossible to predict what changes in facts and circumstances may take place during this interim, it is highly unlikely that complaint counsel, by creating five new independent one-plant wholesale bakers, can accomplish their intended purpose of restoring the competition that was lessened by the exit of independent wholesalers from the various markets. I am also of the opinion that the targeting of individual plants for divestiture at this time is not appropriate. If ultimately, such a style of divestiture is deemed appropriate, the designation of the individual plants to be divested should be made on the basis of the competitive realities and financial conditions that exist at the time of the divestiture. [101]

During the hearings, complaint counsel's expert witnesses also proposed the divestiture of groups of Continental bakeries in geographic proximity to one another. They also recommended that ITT be required to divest Continental.

It is not clear why complaint counsel have abandoned these alternative forms of divestiture. In my opinion, the practices of selling below cost and discriminating in price over relatively long periods of time in selected marketing areas for the purpose of driving competitors out of the market or "conditioning" them to accept and follow Continental's price leadership was only possible due to respondents' vast economic resources with which they subsidized the losses incurred by their individual bakeries which were engaged in such practices. The only way to ensure that such economic power is not misused in the future is to eliminate the source of the power which appears to engender such anticompetitive practices. Complaint counsel appear to rely upon such a rationale regarding the proposal to have Continental divest its Salt Lake City plant.

The Administrative Law Judge recommends to the Commission that it consider ordering ITT's divestiture of Continental and the restructuring of Continental, with or without divestiture, into financially autonomous regional wholesale bakery units. This restructuring of Continental should overcome the problems inherent in situations where individual bakeries do not have the capability of producing a full line of bread products, a fact which makes the divestiture of individual plants impracticable. With the possible exception of some transshipments of products from the Braun bakery in Pittsburgh to the Youngstown and Akron bakeries, there does not appear to have been any serious product interdependence between Continental's regions.

Respondents' objections to the provision of the order banning future acquisitions are well taken. The record in this case does not support any finding that respondents have illegally acquired any bakery or bakery assets during the time periods involved or in the marketing areas which were the subject of this proceeding. In my opinion, such a ban bears no reasonable relationship to the illegal practices in which respondents were found to be engaged.

The paragraph contained in complaint counsel's order that prohibits price discriminations is directed to differences in price between competing customers. It would not appear to cover so-called territorial price discriminations as found to have been implemented in the Minneapolis and Rochester marketing areas. In this respect, the price discrimination prohibition does not appear to be directed at preventing direct subsidization of below cost prices in one marketing area through higher prices in a second marketing area.

Moreover, the proposed price discrimination paragraph could be interpreted, as respondents contend, to prohibit [102] outright any sale of private label or secondary label at any wholesale price lower than the wholesale price of the same size loaf of advertised label bread. The record in this case shows that such a price difference, although discriminatory, may not have an adverse effect on competition if the lower wholesale price for private label bread or secondary label bread is above Continental's competitors' average total costs of producing the same product, including a margin of profit, and where the resulting retail price spread between private label and advertised label bread is not extreme.

Complaint counsel take the position that their price discrimination provision in the proposed order "prohibits unlawful price discriminations." In my opinion, a separate paragraph covering private label and secondary label bread should be included in the order which adopts some of the statutory language relating to competitive effects. Such an all inclusive provision would clarify the ambiguities that appear in the version proposed by complaint counsel. In addition, a paragraph will be added prohibiting territorial price discriminations resulting in prices on advertised label bread that undercut the prevailing market price for advertised label bread and injure competition between competing wholesale bakers.

The "meeting competition" and other statutory exceptions or defenses are implicit in any price discrimination order, unless specific determination is made that certain conduct does not meet the requirements of the statute, such as selling below fully allocated costs.

The absolute ban on sales below Continental's fully allocated costs appears to be unreasonably harsh. Although respondents must expect some "fencing in," the order should not place them in an impossible business position. *See Federal Trade Commission* v. *National Lead Co.*, 352 U.S. 419, 431 (1957). The principal vice found in this case is the predatory use of sales below fully allocated costs to take business away from competing wholesale bakers in selected markets. In my opinion, sales below Continental's fully allocated costs should be permitted only in situations where competing wholesale bakers are actually selling below Continental's fully allocated costs and where Continental affords a price below fully allocated costs to retain the business of a specific customer.

For the above reasons, the provisions of the order relating to divestiture, compulsory licensing and future acquisitions will be deleted from complaint counsel's proposed order. The price discrimination and sales below cost provisions will be modified to conform with the views expressed in this section of the initial decision. [103]

ORDER

For purposes of this order, the term *respondents* refers to respondents International Telephone & Telegraph Corp. and ITT Continental Baking Company, Inc., and the successors, assigns, officers, directors, agents, representatives, employees, subsidiaries, and affiliates of either of them and the term *bread* refers to the products encompassed by the Bureau of Census' Standard Industrial Classification Codes 20511 and 20512 (1973), commonly known as bread and bread type rolls.

I

It is ordered, That respondents, directly or indirectly, in connection with the sale of bread in or affecting commerce, as "commerce" is defined in the amended Clayton Act, shall cease and desist from discriminating, directly or indirectly, in the price of advertised label bread between purchasers in the same line of commerce, by granting a price reduction from the established market price in any market where respondents are in competition with any other wholesale baker if the effect of the lower price may be to substantially injure competition between respondents and their competitors engaged in the wholesale baking business in the market in which the price reduction is granted unless it proportionally reduces its prices everywhere on the same advertised label bread products.

II

It is further ordered, That respondents, directly or [104] indirectly, in connection with the production, marketing and sale of bread in or affecting commerce, as "commerce" is defined in the amended Clayton Act, shall forthwith cease and desist from discriminating in the price of any advertised label bread product and the price of any private label or secondary label bread product of like grade and quality by selling to any purchaser at a higher price than the price charged any other purchaser who, in fact, competes with the purchaser paying the higher price and where the effect of such discrimination may be substantially to lessen competition between respondents and their competitors engaged in the wholesale baking business or between respondents' customers paying the higher price and respondents' customers paying the lower price.

III

It is further ordered, That respondents, directly or indirectly, in connection with the production, marketing and sale of bread in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, shall forthwith cease and desist from selling any bread product below their fully allocated costs; *provided* that nothing herein contained shall prevent respondents from selling below their fully allocated costs in order to retain an established volume of business with specific customers and where competing wholesale bakers are actually selling identical products at the price at which respondents sell such products below their fully allocated costs. **[105]**

IV

It is further ordered, That respondents shall maintain, at all times, records of its cost of producing and distributing each bread product. Such records shall be kept up to date so that no such record is more than six months old. The costs of manufacturing, selling and distribution and overhead shall be reflected in such records, so that the fully allocated cost of each product can be ascertained. The fully allocated, incremental, average variable or marginal cost reflected in any such records shall be binding upon respondents in any enforcement proceeding involving violation of Paragraphs I, II and III of this Order. In the event the costs of any bread product is at issue in an enforcement proceeding involving violations of Paragraphs I, II and III of this Order and respondent cannot produce such a cost record of a product at issue, respondents may not object to the use of a cost record pertaining to an advertised label of the same grade and quality as a product at issue to show the costs of a product at issue. Such cost records shall be kept for ten years.

V

It is further ordered, That respondents shall, within sixty (60) days after the date of service of this Order submit in writing to the Federal Trade Commission a verified report **[106]** setting forth in detail the manner and form in which respondents intend to comply, are complying or have complied with this Order.

VI

It is further ordered, That respondents notify the Commission at least thirty (30) days prior to any proposed change in the corporate respondents such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or of any other change in the corporation which may affect compliance obligations arising out of the Order.

OPINION OF THE COMMISSION

By DOUGLAS, *Commissioner:*

Introduction

The complaint in this matter alleges that International Telephone and Telegraph Corporation, through its wholly owned subsidiary ITT Continental Baking Company, Inc. (hereinafter referred to as "Continental"), violated Section 5 of the Federal Trade Commission Act, 15 U.S.C. 45 (by violating Section 2 of the Sherman Act, 15 U.S.C. 2), and Section 2(a) of the Clayton Act, as amended by the Robinson-Patman Act, 15 U.S.C. 13(a).[1] Count I of the complaint alleges that Continental engaged in the following practices, *inter alia:*

> (1) Sales of bread [at prices] below . . . cost or at predatory prices for substantial periods of time in various geographic markets; [2]
>
> (2) Subsidization of sales below cost or at predatory prices in various geographic markets by sales at higher prices in less competitive geographic markets;
>
> (3) Discriminations in price, directly or indirectly, between purchasers of bread of like grade and quality.[2]

Count I concludes by alleging that these practices represented an attempt by Continental

> to monopolize and injure competition in the wholesale baking industry in relevant geographic markets in violation of Section 5 of the Federal Trade Commission Act.

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[1] The following abbreviations are used in this opinion:

ID – initial decision page number
IDF – initial decision finding number
Tr. – transcript of testimony page number
CX – complaint counsel's exhibit number
CAP – complaint counsel's appeal brief
CAB – complaint counsel's answering brief
CRB – complaint counsel's reply brief
CMF – complaint counsel's memorandum supporting proposed findings of fact and conclusions of law
CPF – complaint counsel's proposed finding of fact number
RX – respondent's exhibit number
RAP – respondent's appeal brief
RAB – respondent's answering brief
RRB – respondent's reply brief
RMF – respondent's memorandum supporting proposed findings of fact and conclusions of law
RPF – respondent's proposed findings of fact number

[2] For the purposes of the complaint, "bread" is defined to encompass "white pan bread and bread type rolls and related products."

Count II of the complaint alleges, *inter alia*, that Continental discriminated

> in price, directly or indirectly, between different purchasers of bread, by selling bread of like grade and quality to some of such purchasers at substantially higher prices than to other of such purchasers.

Count II concludes by alleging that these practices violated Section 2(a) of the Clayton Act, as amended by the Robinson-Patman Act.[3]

The Administrative Law Judge (ALJ) determined that Continental sold white bread products at predatory and discriminatory prices for significant periods of time in five relevant geographic markets: Cleveland, Denver, Northern California and Western Nevada, Southern California, and the Twin [3] Cities of Minneapolis and St. Paul.[4] The ALJ concluded that Continental had attempted to monopolize white bread product sales in each of those markets; should be held liable for primary-line price discrimination in each of those markets; and should be held liable for secondary-line price discrimination in the Cleveland and Northern California/Western Nevada markets.[5] The ALJ issued an order that would prohibit Continental (1) from discriminating in the sale of advertised label and private label bread products, where the effect of the discrimination might be to substantially injure or lessen competition among competing sellers, or to "substantially lessen competition" among competing buyers; and (2) from selling such products at prices below fully allocated costs, with certain exceptions.[6]

On appeal, Continental argues that it did not attempt to monopolize the relevant markets or engage in illegal price discrimination, and that the complaint in this matter should be dismissed. Complaint counsel argue that the findings and order of the ALJ should be sustained, and that in addition the Commission should (1) require Continental to divest its "plants, [4] equipment and other assets" located in Sacramento and Beverly Hills, California; Akron, Ohio; Minneapolis, Minnesota; and Salt Lake City, Utah; and (2) prohibit Continental, for ten years, from acquiring any bread manufacturing facility without first securing Commission approval.

The complaint raises important questions as to the extent to which the Commission should act to prevent firms from selling at allegedly predatory or discriminatory prices. As a general proposition, firms should be accorded the discretion to set prices at whatever levels they choose in response to competitive conditions, since permitting that flexibility is most likely to maximize consumer welfare. Section 2 of the Sherman Act and Section 2(a) of the Clayton Act are intended, *inter alia,* to prevent pricing conduct that injures competition and therefore reduces consumer welfare. However, as we noted in *General Foods,* overly broad efforts to apply these standards may sometimes chill "the rivalry that is the essence of dynamic competition" by discouraging aggressive price and non-price competition.[7] Therefore, the legal and economic standard for evaluating allegedly predatory or discriminatory conduct should carefully distinguish the structural conditions and behavioral patterns that are likely to improve competitive performance from those that are likely to injure competition. We have concluded that Continental's conduct did not violate either the Federal Trade Commission Act or the Clayton Act, and have therefore determined to dismiss the complaint in this matter in all respects. [6]

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[3] The complaint contains a variety of other allegations, but the allegations described above represent the gravamen of the complaint and subsume all its other allegations.

[4] The ALJ concluded that Continental did not attempt to monopolize a sixth relevant geographic market in Seattle, Washington. Complaint counsel have not appealed that determination.

[5] Primary line discrimination cases under the Clayton Act address injury to competition among rival sellers, while secondary line discrimination cases address injury to competition among favored and disfavored buyers.

[6] The order would permit sales at prices below fully allocated cost in order to "retain an established volume of business with specific customers," where "competing wholesale bakers are actually selling identical products" at the same price.

I. INDUSTRY CHARACTERISTICS

The International Telephone & Telegraph Corporation is a large corporation whose $10.2 billion in sales placed it ninth among domestic corporations in 1973. IDF 1. Continental, its wholly owned subsidiary, manufactures and distributes a wide variety of food products, including bread, cake, snacks such as potato chips, and frozen prepared foods. In 1972, Continental's total net sales amounted to $865 million. IDF 2. Continental has been the largest bread and snack cake baker in the United States since 1924; in 1970, its $375 million in sales of these products represented 12.4 percent of total industry sales nationwide.[8] In 1973 its bread sales amounted to approximately $445 million; by 1977, they had increased in nominal terms to $609 million.[9] Continental's largest competitors in wholesale baking include Campbell-Taggart, American Baking Company, Interstate Brands Corporation, Flowers Bakery, and Metz Baking Company. IDF 10. In addition, it confronts substantial competition from the large captive bakeries that many retail grocery chains operate to produce most of the bread they sell in their retail stores. *See* IDF 19.

Wholesale bakers typically produce white bread, hamburger buns, and hot dog rolls, as well as variety breads such as whole [7] wheat, rye, and pumpernickel breads. IDF 20. Economies of scale are important in the baking industry; moreover, wholesale bakers must operate their bakeries at approximately eighty percent of maximum production capacity (encompassing two full production shifts and some overtime) in order to maximize production efficiency.[10] The costs of producing white bread are generally uniform among bakeries. However, chain store bakers enjoy a distributional cost advantage that is attributable to differences in delivery methods.[11]

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[7] *General Foods Corp.,* 3 Trade Reg. Rep. (CCH) ¶22,142 (April 6, 1984), at 22,973. [103 F.T.C. 204 (1984)]

[8] IDF 4; *ITT Continental Baking Co.,* 84 F.T.C. 1349, 1395 and n.4 (1974).

[9] IDF 3, 43. In constant 1973 dollars (as adjusted by the producer price index for total finished goods), Continental's bread sales actually declined to $429 million in 1977. *See Economic Report of the President* (February 1, 1984), at 285.

Most wholesale bakers sell bread primarily to retail grocery stores; their other bread customers include restaurants, institutions, and hotels.[12] Continental and most other wholesale bakers market an "advertised label" line of bread products sold under a brand name that is usually owned and promoted by the wholesaler. Continental's principal advertised brand is "Wonder Bread," it accounts for most of its white bread sales. IDF 29. Continental and most other wholesalers also sell "private label" bread products—usually including the most popular white bread [8] loaf sizes, and hamburger and hot dog rolls—that are packaged for sale under the private labels of retail grocery store chains. IDF 30. Finally, some wholesalers sell "secondary label" bread to independent grocers that are too small to have their own private label programs.[13] Nearly all remaining bread that is sold in retail outlets is "captive label" bread; that is, it is produced by the retail grocery chain that sells it. In 1971, captive and private label bread accounted for thirty-six percent of total white bread sales in the United States; by 1977, that percentage had climbed to approximately fifty percent. IDF 32, 38. Most retail grocery stores, including chains with their own bakeries, will carry limited quantities of the advertised label breads of each of the wholesale bakers active in a given area. IDF 34.

The "quality, nutrition, palatability and physical features" of white bread are relatively similar from one brand to another.[14] The wholesale and retail prices of advertised label bread are typically higher than those of private, captive, controlled, and secondary label breads, largely because wholesale bakers have been able to create consumer franchises for their [9] advertised label bread products. IDF 35, 36. However, as the size of this price differential increases, advertised label bread loses more and more sales to private, captive, controlled and secondary label breads. Conversely, as the size of the differential declines, these other types of labels lose more and more sales to advertised label breads. IDF 36.

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[10] IDF 23; Shaus, Tr. 11204-05, 11223-24; *see* Jakacki, Tr. 10295, 10300-02.

[11] IDF 27. Retail chain stores use semitrailers, driven by hourly rate Teamsters, to deliver their bread to the "doors" of their retail outlets, for shelf placement by their own employees. By contrast, wholesale bakers generally use more highly paid "route salesmen"—Teamsters who earn a salary plus coommission—to distribute their bread products to retail grocery stores and restaurants, and place the bread on the shelves. IDF 25-27.

[12] IDF 24. For example, restaurants and institutional accounts represent approximately thirteen percent of Continental's total route sales. *Id.*

[13] IDF 31. A wholesaler may also sell bread to a given retailer under a label that the wholesaler controls, but to which the retailer is accorded exclusive license in a particular area. This bread is referred to as "controlled label" bread because the label is ultimately controlled by the wholesaler rather than by the retailer. *Id.*

[14] IDF 35. This does not mean, however, that all white bread should be considered to be identical. There are of course some quality, nutrition, palatability, and physical differences among brands.

The bread industry has undergone some very substantial changes over the last twenty years, and an earlier Commission case involving Continental produced some useful evidence as to competitive conditions during the time period at issue in this case. In 1962, the Commission issued a consent order against Continental that, *inter alia*, prohibited it from acquiring any interest in, or the assets of, any concern engaged in the production and sale of bread and bread-type rolls without Commission approval.[15] In 1968, International Telephone & Telegraph acquired Continental as a wholly-owned subsidiary.[16] On April 27, 1972 the Commission issued an order requiring Continental to show cause why the Commission should not extend the acquisition ban for an additional five years.[17] On November 26, 1974—the same day it issued the complaint in this matter—the Commission reversed the decision of the [10] Administrative Law Judge to extend the ban on acquisitions without Commission approval and dismissed the order to show cause.[18]

The opinion of the Administrative Law Judge in the earlier case provides a useful overview of economic conditions in the bread baking industry between 1963 and 1973. The ALJ found that the number of plants and producers in the industry had declined substantially during that period, and suggested a number of explanations for the industry's problems:

> At least since the beginning of 1973, 90 percent of all wholesale bakeries have been operating at a loss. The president of Quality Bakers of America estimated that about 50 percent of his cooperative members are running in the red and that the industry is in a state of disaster. Wards went through a radical reorganization. Interstate was almost acquired by Beatrice Foods. Most wholesalers are closing plants. Many smaller bakers are going out of business.
>
> The wholesale bakers' problems have been caused, in large part, by the activities and growth of chain bakeries, costly labor contracts, technological improvements that have created overcapacity, improved highways permitting larger areas to be served by a single plant, high ingredient, selling and distribution costs, problems arising from Federal price controls in effect since Aug. 1971, and the decline in per capita consumption of bread. Of particular current impact is the tremendous [11] increase in the cost of flour following the shipment of flour to Russia in 1972 and the corresponding short

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[15] *Continental Baking Co.*, 60 F.T.C. 1183, 1193–94 (1962) (consent order).

[16] *ITT Continental Baking Co.*, 84 F.T.C. 1349, 1393–94 (1974).

[17] *Id.* at 1394.

[18] *ITT Continental Baking Co.*, 84 F.T.C. 1349, 1400. Although it is not completely clear from the record, the Commission may have issued the complaint in this matter because it was not sure—as of 1974—"whether competition in the various local and regional markets in the country was increasing, decreasing, or holding steady . . ." and whether any such changes were attributable to merger activity "or to some other cause or causes . . ." *Id.* at 1394–95.

supply here coupled with the inability to recoup costs because of price controls. These factors are generally found, to varying extents, in all markets, whether or not ITT Continental is present.[19]

In its opinion dismissing the show cause order, the Commission confirmed the ALJ's assessment of the economic condition of the bread baking industry:

> The number of bread producers has been declining sharply for many years . . . While a substantial number of these departing firms were acquired by the larger members of the industry in the pre-1964 period, a major factor here has clearly been a series of technological changes in the industry that have significantly increased the minimum efficient plant size. As more and more firms have sought to get their per-unit costs down to the minimum level by incorporating the newer and lower-cost technology in their plants, the productive capacity of the industry has sharply outstripped the growth in consumer demand. The result is that the industry has been suffering from chronic excess capacity for many years, a situation that of course further intensifies the competitive struggle [12] for volume.[20] The smaller firms, especially those with older plants and equipment, have thus found themselves operating not only high-cost facilities but operating them at less than full capacity. Not being able to match the lower costs and prices of their more technologically advanced rivals, many of these smaller firms have been forced to either close their doors or sell out to other firms in the industry.[21]

In short, during the 1963–1973 period, the bread baking industry confronted substantial and chronic excess capacity created largely by technological improvements; high ingredient, selling and distribution costs; Federal price controls that became effective in August, 1971; and a decline in *per capita* bread consumption. These conditions existed to varying degrees in all parts of the country, regardless of the presence or absence of Continental in any particular market. It is therefore not surprising that a number of firms left the industry during this period, and that a large number of other firms suffered losses; indeed, it would be surprising if a period of such widespread economic and technological change did not produce precisely those effects that are the gravamen of the complaint in this matter. [13]

The record evidence developed since the complaint was issued provides no reason to conclude that any of the economic conditions the Commission described in its 1974 opinion should be attributed to Continental's pricing behavior in any of the relevant geographic markets. The Commission has therefore determined to dismiss the complaint in this matter in all respects. A more detailed discussion of the attempted monopolization and price discrimination allegations follows.

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[19] *Id.* at 1381 (Initial Decision) (citations omitted). The ALJ concluded that the acquisition restriction in the 1962 order should be extended until April 13, 1977. He based this conclusion principally upon the fact that "industrywide concentration" had increased *nationwide* since 1962, despite his determination that the relevant geographic markets were regional or local, and the absence of evidence that Continental's alleged acquisitions had increased concentration in any relevant regional or local market. *Id.* at 1387–90. The Commission reversed because of the absence of evidence of injury to competition in the relevant local bread markets. *Id.* at 1399.

[20] The Commission noted, for example, that in 1958 the industry was reportedly operating at only forty percent to sixty percent of capacity. *Id.* at 1396 n.12. The ALJ in this case concluded, by contrast, that there was "no chronic excess capacity in the bread baking industry during the relevant periods." ID at 19. However, the record evidence does not support that conclusion. *See* Metz, Tr. 10223; Jakacki, Tr. 10273–76; CX 1355; RX 1000; RX 1101.

[21] *ITT Continental Baking Co.*, 84 F.T.C. at 1396 and n.12.

II. SECTION 2 OF THE SHERMAN ACT: ATTEMPTED MONOPOLIZATION

In its classic formulation of the offense of attempted monopolization, the Supreme Court determined:

> Where acts are not sufficient in themselves to produce a result which the law seeks to prevent—for instance, the monopoly—but require further acts in addition to the mere forces of nature to bring that result to pass, an intent to bring it to pass is necessary in order to produce a dangerous probability that it will happen.[22]

Somewhat more recently, the Commission has described the elements of the offense in the following fashion: [14]

> . . . [T]he attempt offense includes three principal elements: (1) specific intent to control prices or destroy competition, (2) exclusionary or anticompetitive conduct, and (3) a dangerous probability of success.[23]

This portion of the opinion discusses each of these elements in some detail.

A. *Specific Intent*

Proving the first element of the attempted monopolization offense requires establishing a specific intent to control prices or otherwise injure competition.[24] However, the Commission has [15] emphasized that the specific intent element depends importantly upon the nature of the conduct that a firm employs pursuant to that intent:

> As a general matter, it seems unwise to find that a firm has the requisite specific intent for anticipating the exclusionary consequences of successful competitive behavior

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[22] *Swift & Co. v. United States*, 196 U.S. 375, 396 (1905).

[23] *E.I. Du Pont de Nemours & Co.*, 96 F.T.C. 653, 725 (1980); *accord*, *General Foods Corp.*, *supra* note 7, ¶22,142 at 22,973; *D.E. Rogers Associates, Inc.* v. *Gardner-Denver Co.*, 718 F.2d 1431, 1435 (6th Cir. 1983), *cert. denied*, 52 U.S.L.W. 3886 (U.S. June 12, 1984) (No. 83–1698); *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d 1014, 1027 (9th Cir. 1981), *cert. denied*, 103 S.Ct. 58 (1982); *United States* v. *Dairymen, Inc.*, 660 F.2d 192, 194 (6th Cir. 1981); *Northeastern Telephone Co.* v. *American Telephone & Telegraph Co.*, 651 F.2d 76, 85 (2d Cir. 1981), *cert. denied*, 455 U.S. 943 (1982); *Chillicothe Sand & Gravel* v. *Martin Marietta Corp.*, 615 F.2d 427, 430 (7th Cir. 1980); *California Computer Products, Inc.* v. *IBM Corp.*, 613 F.2d 727, 736 (9th Cir. 1979); *Pacific Engineering & Production Co.* v. *Kerr-McGee Corp.*, 551 F.2d 790, 791 (10th Cir. 1977); *Merit Motors, Inc.* v. *Chrysler Corp.*, 417 F.Supp. 263, 269–70 (D.D.C. 1976), *aff'd*, 569 F.2d 666 (D.C. Cir. 1977).

[24] *Times Picayune Publishing Co.* v. *United States*, 345 U.S. 594, 626 (1953) ("a specific intent to destroy competition or build monopoly"); *D.E. Rogers Associates, Inc.* v. *Gardner-Denver Co.*, 718 F.2d at 1435 ("specific intent to monopolize"); *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d at 1027 ("specific intent to control prices or destroy competition"); *Northeastern Telephone Co.* v. *American Telephone & Telegraph Co.*, 651 F.2d at 85 ("specific intent to monopolize"); *Chillicothe Sand & Gravel* v. *Martin Marietta Corp.*, 613 F.2d at 430 ("specific intent to control prices or destroy competition"); *United States* v. *Empire Gas Corp.*, 537 F.2d 296, 302 (8th Cir. 1976) ("an intent to control prices or to restrict competition unreasonably"), *cert. denied*, 429 U.S. 1122 (1977).

> which leads or may lead to a monopoly, so long as that behavior is reasonable. To suggest otherwise would be to proscribe all acts in which firms conjure up some thoughts of achieving monopoly irrespective of the actual character of the means employed to gain that end.[25]

In short, although evidence of a specific intent to injure or destroy competition can be helpful in establishing liability for attempted monopolization, its utility depends crucially upon the nature of the conduct at issue. Any successful business strategy will injure competitors to some degree; it satisfies the specific intent requirement only if it contemplates doing so by means of anticompetitive conduct. As the Commission recently stated, the specific intent element

> is not satisfied by ambitious and aggressive plans to compete, even with the goal of taking business from competitors or vanquishing a troublesome rival. The [16] antitrust laws provide no protection from such designs, where the means to effectuate them amount to no more than vigorous competition.[26]

B. *Anticompetitive Conduct*

Proving the second element of the attempted monopolization offense requires a thorough evaluation of the conduct that the firm involved employed. In *DuPont*, the Commission determined that essentially three criteria should be considered in conducting such an evaluation: (1) whether firms without substantial market power would find the conduct at issue to be profitable or economically rational; (2) whether the conduct improves product performance; and (3) whether industry conditions such as high entry barriers are likely to mitigate or accentuate any anticompetitive effects of the conduct.[27] When properly defined, predatory pricing satisfies these criteria, because it is highly unlikely that firms without substantial market power will find it either profitable or otherwise economically rational; it is highly unlikely to improve product performance; and whether it will prove to be successful is largely a function of a variety of structural industry characteristics. Of course, a determination that a given firm has sold at predatory prices for a significant period of time does not in and of itself establish liability under the Sherman Act or the Clayton Act. It satisfies the "specific intent" and [17] "anticompetitive conduct" components of the attempted monopolization offense, but does not, without more, satisfy the "dangerous probability of success" requirement. It also satisfies the "predatory pricing" requirement for primary-line liability under Section 2(a) of the Clayton Act, but does not satisfy the jurisdictional requirements of that section.

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[25] *E.I. Du Pont de Nemours & Co.*, 96 F.T.C. 653, 727 (1980); *accord, e.g., General Foods Corp., supra* note 7, ¶22,142 at 22,974; *D.E. Rogers Associates, Inc.* v. *Gardner-Denver Co.*, 718 F.2d at 1435; *Williams Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d at 1028, 1031 n.18; *Lektro-Vend Corp.* v. *Vendo Co.*, 660 F.2d 255, 273 (7th Cir. 1981); *Buffalo Courier Express, Inc.* v. *Buffalo Evening News, Inc.*, 601 F.2d 48, 54 (2d Cir. 1979); *Hayes* v. *Solomon*, 597 F.2d 958, 977 (5th Cir. 1979), *cert. denied*, 444 U.S. 1078 (1980).

[26] *General Foods Corp., supra* note 7, ¶22,142 at 22,974 (citations omitted).

[27] *E. I. Dupont*, 96 F.T.C. 653, 738–39 (1980).

The difficult question is of course how to define predatory pricing. It is crucially important to distinguish prices that are perfectly consistent with competitive behavior from prices that are not. Price is the "central nervous system" of the economy,"[28] and vigorous and healthy competition engenders economic efficiency which redounds to the benefit of consumers. By contrast, overly zealous efforts to prevent sales at prices below cost are likely to reduce competition and increase prices.[29] Therefore, we must carefully avoid adopting a predatory pricing rule that will deter legitimately competitive pricing conduct. The significant likelihood of injury to competition from erroneously prohibiting low prices should be contrasted with the low likelihood that an unrestrictive rule [18] will erroneously permit anticompetitive conduct, given the low likelihood that any predatory strategy will prove successful. As Phillip Areeda and Donald Turner have pointed out,

> proven cases of predatory pricing have been extremely rare. . . . That predatory pricing seems highly unlikely does not necessarily mean that there should be no antitrust rules against it. But it does suggest that extreme care be taken in formulating such rules, lest the threat of litigation . . . materially deter legitimate, competitive pricing.[30]

An ideal predatory pricing rule must therefore satisfy two criteria. First, it must distinguish predatory intent from competitive intent; that is, it must distinguish pricing behavior that is very likely intended to injure competition from pricing behavior that could very well be directed toward perfectly legitimate competitive objectives. Sales at prices below average variable cost—as properly defined—for a significant period of time may well satisfy this requirement. They are more likely intended to injure competition than to achieve legitimate competitive objectives because they do not cover any fixed costs of operation, and do not cover all of the variable costs of operation. The firm that sells at such prices consequently loses [19] more money by continuing to operate than by shutting down altogether. Sustained sales at such prices can therefore be presumed to be intended to injure competition.[31]

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[28] *United States* v. *Socony-Vacuum Oil Co.*, 310 U.S. 150, 224–26 n. 59 (1940).

[29] The National Recovery Administration's effort to enforce its code against "destructive price cutting" provides a good example of this latter phenomenon. An economist associated with the program and a contemporary Brookings Institution study separately concluded that extensive enforcement of the code tended to reduce competition, to raise prices, and, in some cases, to injure small competitors that could not capitalize upon their greater efficiency. *See* L. Lyon *et al.*, *The National Recovery Administration: An Analysis And An Appraisal* 604–05 620–21 (1935); C. Roos, *NRA Economic Planning* 249, 256–59, 275, 407–08, 416 (1937).

[30] P. Areeda and D. Turner, III *Antitrust Law* 152 (1978). At least two commentators have argued that predation is so rare that it should be completely ignored, in order to avoid deterring legitimate competitive pricing. R. Bork, *The Antitrust Paradox* 149–155 (1978); Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. Chi. L. Rev. 263 (1981).

An ideal predatory pricing rule must secondly distinguish pricing behavior that is likely to injure competition in the generality of cases from pricing behavior that is not. The antitrust laws focus upon preserving or enhancing consumer welfare by preserving or enhancing competition. One effect of healthy competition is to redirect production and sales from less efficient firms to more efficient rivals. Therefore, one logically ought to determine the pricing level that is likely to force equally efficient firms to shut down, with the effect of injuring competition.[32] A price that forces an equally efficient [20] firm to sell at a price below its own average variable costs for a significant period of time satisfies this criterion. Because sales at such prices do not even cover the variable costs of operation, an equally efficient firm will ordinarily shut down completely rather than continue to operate. Since its shutdown is induced not by competitive conditions but rather by anticompetitive conduct on the part of the predatory firm, it injures competition and therefore worsens consumer welfare.

The most appropriate predatory pricing rule will therefore satisfy two separate requirements: (1) a predatory *intent* requirement—sales at prices below average variable cost for a significant period of time; and (2) a predatory *conduct* requirement—sales at prices that are likely over a significant period of time to force equally efficient firms to shut down completely. Sales at prices below the average variable costs of an alleged predator for a significant period of time will presumptively satisfy both of these criteria. The Commission has therefore concluded that it should rely upon average variable cost to distinguish presumptively legitimate prices from presumptively predatory prices, in the following fashion:

(1) *Sales at prices that equal or exceed average variable cost should be strongly, often conclusively, presumed to be legal.* This presumption could possibly be rebutted in some circumstances [21] by a strong showing that sales at such prices were not, absent the effect of the alleged predation, consistent with profit maximization or loss minimi-

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[31] This analysis of predatory intent focuses upon average variable cost rather than marginal cost to distinguish predatory from competitive objectives. *Compare, e.g.,* P. Areeda and D. Turner, III *Antitrust Law* 153 (1978). That is because a firm will produce at an output at which marginal cost equals price (average revenue) only under perfectly competitive conditions. Any firm with some degree of market power—that is, any firm that confronts a downward-sloping demand curve, and is therefore to some degree a price *maker* rather than a price *taker*—will seek to maximize profits or minimize losses by selling at the point at which (declining) marginal revenue equals marginal costs, rather than at the point at which (a constant) *price* equals marginal cost.

[32] Two firms are "equally efficient" if each firm minimizes its average total costs at the same level. Scherer, *Predatory Pricing and the Sherman Act: A Comment,* 89 Harv. L. Rev. 868, 872 n.10 (1976); *Transamerica Computer Co. v. IBM Corp.,* 481 F.Supp. 965, 991, 992 (N.D. Cal. 1979), *aff'd,* 698 F.2d 1377 (9th Cir. 1983), *cert. denied,* 104 S.Ct. 370 (1983); *see* R. Posner, *Antitrust Law: An Economic Perspective* 188–89. When this is the case, each firm can produce a given quantity of output with precisely the same quantity of resources.

zation.[33]

(2) *Sales at prices below average variable cost for a significant period of time should be rebuttably presumed to be anticompetitive.*[34] This presumption could be rebutted by showing, for example, that the sales at issue (1) were of products that were obsolete, perishable, or otherwise subject to rapid value deterioration; (2) were at introductory prices designed to induce trial; or (3) were [22] made to avoid losing goodwill, such as product loyalty, that it would be very costly to regain were the firm to shut down and then reopen later.[35]

(3) *Sales at prices that equal or exceed average total cost should be conclusively presumed to be legitimate.*[36] Sales at such prices cannot by definition exclude equally efficient firms. They may, of course, exclude less efficient firms, but that is often an effect of vigorous and healthy competition. [23]

Two important considerations should be addressed in conjunction with this standard. First, although it is difficult to precisely determine the duration of a "significant" time period, it should be sufficiently long to make it likely that sales at prices below average variable cost could in fact force equally efficient firms to exit. Discontinuous or episodic instances of sales at such prices are unlikely to satisfy this standard, because they may very well be nothing more than responses to fluctuating demand and in any event are unlikely to be sufficiently long-lived to exclude equally efficient firms. Second, the difficulty of identifying the costs that should be treated as variable in any given situation should not be underestimated. As the Commission pointed out in *General Foods Corp.*, it will often be difficult to allocate joint variable production, distribution, or promotional costs among different brands of a given product, among different products, or among different geographic areas.[37] Moreover, it will frequently be difficult to distinguish the investment or fixed cost component [24] of promotional expenses from the variable cost or current expense component. As the Commission has indicated:

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[33] *General Foods Corp., supra* note 7, ¶22,142 at 22,975–76 (citations omitted). Complaint counsel argue that this standard should not apply "when predatory pricing can be cross-subsidized currently from profits in the predator's more secure markets." CAB at 16. However, even if a firm earns greater profits in some markets than in others, sales at prices equal to or greater than average variable cost will not make sense as a predatory strategy because they will not force equally efficient firms from those markets, and subsequent recoupment of losses in those markets will therefore not be possible. Complaint counsel also suggest that the legitimacy of sales at prices below "full [unit] cost" should vary with the degree to which, and the sales volume and duration for which, such prices fall below full cost. CAB at 26–27. Apart from its conflict with the strong presumptive legitimacy of prices equal to or greater than average variable cost, the "rule of reason" standard complaint counsel propose would be very difficult to apply in practice, with very uncertain results, and we therefore decline to adopt it.

[34] *General Foods Corp., supra* note 7, ¶22,142 at 22,975–76 (citations omitted). The concept of "average variable costs" should probably encompass "reasonably anticipated" average variable costs, to protect sales made in anticipation that costs will fall. P. Areeda and D. Turner, III *Antitrust Law* 154, 174 (1978).

[35] *Buffalo Courier Express* v. *Buffalo Evening News*, 601 F.2d 48, 55 (2d Cir. 1979); *General Foods Corp., supra* note 7, ¶22,142 at 22,975; P. Areeda, *Antitrust Law Supplement* 121, 151, 157–58 (1982); *see* P. Areeda and D. Turner, III *Antitrust Law* 176–78 (1978).

Most courts have now concluded that sales at prices equal to or greater than average variable cost should be rebuttably presumed to be legitimate, and that sales at prices below average variable cost should be rebuttably presumed to be predatory. *D.E. Rogers Associates, Inc.* v. *Gardner-Denver Co.*, 718 F.2d 1431, 1437 (6th Cir. 1983), *cert. denied*, 52 U.S.L.W. 3686 (U.S. June 12, 1984) (No. 83–1696); *Transamerica Computer Co.* v. *IBM Corp.*, 698 F.2d 1377, 1386 (9th Cir. 1983); *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d 1014, 1035–36 (9th Cir. 1981), *cert. denied*, 103 S.Ct. 58 (1982); *Superturf, Inc.* v. *Monsanto Co.*, 660 F.2d 1275, 1281 (8th Cir. 1981); *O. Hommel Co.* v. *Ferro Corp.*, 659 F.2d 340, 352–53 (3d Cir. 1981) (dictum); *Northeastern Tel. Co.* v. *AT&T Co.*, 651 F.2d 76, 88 (2d Cir. 1981), *cert. denied*, 455 U.S. 943 (1982); *International Air Industries, Inc.* v. *American Excelsior Co.*, 517 F.2d 714, 724 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976); *see Chillicothe Sand & Gravel Co.* v. *Martin Marietta Corp.*, 615 F.2d 427, 432 (7th Cir. 1980); *Pacific Engineering & Prod. Co.* v. *Kerr-McGee Corp.*, 551 F.2d 790, 797 (10th Cir.), *cert. denied*, 434 U.S. 879 (1977). For two good reviews of the relevant cases, *see* Calvani and Lynch, *Predatory Pricing Under the Robinson-Patman and Sherman Acts: An Introduction*, 51 Antitrust L.J. 375 (1982); Hurwitz and Kovacic, *Judicial Analysis of Predation: The Emerging Trends*, 35 Vand. L. Rev. 63 (1982).

[36] *Arthur S. Langenderfer, Inc.* v. *S.E. Johnson Co.*, 1984–1 Trade Cas. (CCH) ¶65,905 (6th Cir. 1984), at 67,865; *Barry Wright Corp.* v. *ITT Grinnell Corp.*, 724 F.2d 227, 231, 235–36 (1st Cir. 1983); P. Areeda and D. Turner, III *Antitrust Law* 169–70 (1978).

> Promotional outlays or reduced prices that cause current accounting losses may represent an investment in long-lived information and goodwill that will pay off with enhanced future revenues. If so, the investment component should be amortized over the life cycle for which respondent expected it to endure.[38]

With these considerations in mind, we nevertheless believe that relying upon average variable cost represents the most economically sensible and predictable predation standard available.

In her concurring and dissenting opinion, Commissioner Bailey argues that the Commission should instead rely upon industrywide capacity utilization levels to determine whether average variable cost or average total cost should be used to distinguish competitive from predatory pricing. More particularly, she argues that prices that equal or exceed average variable cost may nevertheless be predatory if they fall below average total cost in a market characterized by a high level of capacity utilization. Under her approach, a plaintiff (or [25] complaint counsel) apparently could shift the burden of justifying sales at prices below average total cost to the defendant or respondent by establishing that the industry involved does not confront substantial excess capacity.

There are a number of difficulties with this approach that would make it less desirable as a predatory pricing standard. First, it might very well deter competitive pricing behavior, because there are a variety of legitimate competitive reasons for prices that fall below average total cost but equal or exceed average variable cost. In particular, prices within this range may represent a perfectly legitimate, loss-minimizing response to excess capacity at the *firm* level. As the Ninth Circuit Court of Appeals indicated recently:

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[37] *General Foods Corp.*, *supra* note 7, ¶22,142 at 22,975; *accord*, P. Areeda, *Antitrust Law Supplement* 146 (1982).

[38] *General Foods Corp.*, ¶22,142 at 22,975. Professors Areeda and Turner have argued that all costs except capital costs, taxes unaffected by output, and depreciation should be rebuttably presumed to be variable. P. Areeda and D. Turner, III *Antitrust Law* 173 (1978); P. Areeda, *Antitrust Law Supplement* 147 (1982). Although that approach may be a useful starting point in some respects, we would like to emphasize that the investment or fixed cost component of promotional expenses should *always* be treated as a fixed cost. Of course, as the time period relevant to evaluating an allegedly predatory strategy lengthens more types of costs should be characterized as "variable." In the long run, all costs are variable; at that point, average variable cost and average total cost are therefore equivalent.

> Pricing below average total cost may be a legitimate means of minimizing losses, particularly when the firm is "temporarily" experiencing "excess capacity" in its productive facilities. . . . Prices below the average total cost of production, but above the average variable cost, may represent a legitimate means of minimizing losses during the period of inadequate demand. Such a price will be sufficient to recover the variable costs of production and at least some portion of the firm's fixed costs—those costs that would remain even if [26] the firm ceased production. To discontinue production under these circumstances would increase losses because even that portion of its total fixed costs would be lost.[39]

Moreover, sales at prices within this range are not likely to represent an effective predatory strategy. As long as prices equal or exceed average variable cost, they will not force an equally efficient firm with comparable variable costs to shut down. In fact, an equally efficient rival will ordinarily have a strong incentive to continue production, since prices at that level cover at least the variable costs of production and possibly some fixed costs as well.

Second, for a variety of reasons, measuring the imprecise construct "average total cost" is relatively more difficult than measuring average variable cost. The accounting measure of average total cost during any particular period will not necessarily reflect the long-term value of the underlying investment. Under conditions of competitive equilibrium, the discounted present value of revenue contributions above variable cost that a given investment will produce over its useful life ("quasi-rents") will equal its capital cost. However, the accounting value of revenue over cost may vary considerably over time, causing accounting "profits" in some years (when price [27] exceeds the accounting measure of average total cost) and accounting "losses" in others (when price falls below the accounting measure of average total cost). Moreover, average total costs, as measured by accounting data, include arbitrary measures of depreciation (since there is no "correct" depreciation schedule) and measures of capital cost which are both "embedded" (*i.e.,* reflecting past interest rates and historic costs of capital equipment) and incomplete (not including the opportunity cost of equity). Furthermore, where production takes place jointly with other products, allocating fixed costs among these products must be arbitrary, making the ultimate evaluation of average total costs similarly arbitrary.

Third, relying upon *industrywide* capacity utilization levels to determine when the average total cost standard should be used would not be practicable or appropriate. The concept of "capacity" envisions a discontinuity in the production function which does not typically exist, or at best can be measured against rapidly rising marginal cost only with imprecision. As a consequence, any measure of capacity represents only a very imprecise surrogate for actual capacity. Moreover, predatory pricing requires an assessment of the intent of the alleged predator, and industrywide capacity utilization levels are not really relevant to that assessment. Indeed, in many industries, such as electrical power generation, efficiency mandates some continuous level of "excess" capacity in order to permit rapid responses—in the form of production levels substantially greater than normal—to seasonal or otherwise cyclical peaks in demand. **[28]**

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[39] *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.,* 668 F.2d 1014, 1035 (9th Cir. 1981), *cert. denied,* 103 S.Ct. 58 (1982) (citations omitted). Of course, as the Court points out, sales at such prices over the long run "will not justify renewal of investment at the previous level." *Id.* at 1035. However, the rule we have adopted accounts for this phenomenon because all costs—including investment—are variable in the long run.

The fact that an alleged predator may have recently increased its individual capacity is not likely to be any more helpful. There are, after all, a variety of legitimate competitive reasons for plant expansion, and if a given expansion reduces costs, concurrent or subsequent price reductions to reach optimal utilization levels may be a perfectly logical and competitive corollary.[40] Furthermore, if additions to capacity must be made in large "lumps" because of technological constraints, large expansions will increase fixed costs so that competitively efficient prices may at times fall below average total cost, even though industrywide capacity utilization levels may be high.

The final difficulty with Commissioner Bailey's approach is that it would reduce business certainty, because businesses would need to determine the level and significance of industrywide capacity utilization before deciding whether to follow the average variable cost or the average total cost standard. As a result, many businesses might simply decide to avoid selling at prices below average total cost altogether, regardless of competitive conditions. In conjunction with the other problems outlined above, this factor confirms the preferability of a **[29]** standard that focuses upon average variable cost alone, rather than upon capacity utilization levels and average total or fully allocated cost.[41]

The foregoing discussion explains how the Commission's predatory pricing standard fits into the attempted monopolization offense. However, the Commission has taken the position that in attempted monopolization cases, the dangerous probability of success element should be evaluated "before proceeding to the other two elements."[42] That approach was particularly appropriate in *General Foods* because an accurate evaluation of the extensive price and cost information in that case would have required a very complex and time-consuming evaluation of a variety of relevant data. In the attempted monopolization part [30] of this case, the dangerous probability of success element can be evaluated fairly readily. We therefore proceed to discuss that element.[43]

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[40] *E.I. Dupont de Nemours & Co.*, 96 F.T.C. 653, 747–48 (1980).

[41] It would be particularly inappropriate to rely upon average total cost to distinguish competitive from predatory pricing in the baking industry because—as we have noted *supra*—the industry confronted chronic and substantial excess capacity in most if not all relevant geographic markets throughout the time period at issue in this case. *See* pp. 10–12, *supra*.

[42] *General Foods Corp.*, *supra* note 7, ¶22,142 at 22,977; *E. I. Dupont de Nemours & Co.*, 96 F.T.C. 653, 725–26 (1980).

C. *Dangerous Probability Of Success*

Proving the attempted monopolization offense finally requires establishing that the conduct at issue created a dangerous probability that the firm involved would acquire "the power to control price or exclude competition" in the relevant market(s).[44] This section discusses the legal and economic standards for making such a determination, and then applies them to the facts of this case.

1. Relevant Markets

The first step in evaluating the dangerous probability element is delineating the relevant product and geographic markets within which monopoly power may be acquired.[45] As the Supreme Court has indicated with respect to product market definition: [31]

> To establish monopolization or attempt to monopolize a part of trade or commerce under §2 of the Sherman Act, [one must] appraise . . . exclusionary power . . . in terms of the relevant market for the product involved. Without a definition of that market there is no way to measure [a firm's] ability to lessen or destroy competition.[46]

Most courts have taken the same position with respect to geographic market definition.[47] [32]

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[43] As our discussion of the Clayton Act below indicates, a showing of predatory pricing is an essential element of a primary line price discrimination case, and the test for predatory pricing under the Sherman Act should apply in Clayton Act cases as well. An evaluation of the price and cost data that complaint counsel relied upon in their effort to establish liability *is* required to determine whether Continental violated the Clayton Act in all five of the relevant geographic markets.

[44] *General Foods Corp., supra* note 7, ¶22,142 at 22,976.

[45] In an analogous context, the Supreme Court has repeatedly indicated that "Determination of the relevant product and geographic markets is 'a necessary predicate' to deciding whether a merger contravenes the Clayton Act." *United States* v. *Marine Bancorporation*, 418 U.S. 602, 618 (1974), *quoting United States* v. *DuPont & Co.*, 353 U.S. 586, 593 (1957).

[46] *Walker Process Equipment, Inc.* v. *Food Machinery & Chemical Co.*, 382 U.S. 172, 177 (1965); *accord, Super Turf, Inc.* v. *Monsanto Co.*, 660 F.2d 1275, 1283 (8th Cir. 1981); *Spectrofuge Corp.* v. *Beckman Instruments, Inc.*, 575 F.2d 256, 276 (5th Cir. 1978); *United States* v. *Empire Gas Corp.*, 537 F.2d 296, 298–99 (8th Cir. 1976), *cert denied*, 429 U.S. 1122 (1977); *Coleman Motor Co.* v. *Chrysler Corp.*, 525 F.2d 1338, 1348–49 (3d Cir. 1975); *George R. Whitten, Jr., Inc.* v. *Paddock Pool Bldrs., Inc.*, 508 F.2d 547, 550 (1st Cir.), *cert. denied*, 421 U.S. 1004 (1974); *Mullis* v. *ARCO Petroleum Corp.*, 502 F.2d 290, 295 (7th Cir. 1974); *Merit Motors, Inc.* v. *Chrysler Corp.*, 417 F.Supp. at 269–70. Only the Ninth Circuit has suggested that market definition may not be a prerequisite to attempted monopolization liability, although its most recent decisions require a showing of a "specific intent to control prices or destroy competition with respect to a part of commerce" in order to establish attempted monopolization. *Compare Transamerica Computer Co.* v. *IBM Corp.*, 698 F.2d at 1382; *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d at 1027 *with Greyhound Computer Corp.* v. *IBM*, 559 F.2d 488, 504 (9th Cir. 1977), *cert. denied*, 434 U.S. 1040 (1978); *Lessig* v. *Tidewater Oil Co.*, 327 F.2d 459, 474–75 (9th Cir. 1964), *cert. denied*, 377 U.S. 993 (1964).

Reliable measures of supply and demand elasticities provide the most accurate estimates of relevant markets.[48] However, it is ordinarily quite difficult to measure cross-elasticities of supply and demand accurately.[49] Therefore, it is usually necessary to consider other factors that can serve as useful surrogates for cross-elasticity data. In the case of geographic market definition, these factors may include

> the extent of different price changes and patterns from region to region; the level of barriers to trade flow between regions (including high transportation costs relative to product value); the degree of product shipping from one region to another (*i.e.*, transshipment); and the perceptions of competition from distant firms on the part of industry members.[50]

In the case of product market definition, these factors may include

> whether the products and services have sufficiently distinctive uses and characteristics; whether industry firms routinely monitor each other's actions and calculate and adjust their own prices (at least in part) on the basis of other firms' prices; the extent to which consumers consider various categories of sellers . . . as substitutes; and whether a sizeable price [33] disparity between the different types of . . . sellers . . . persists over time for equivalent amounts of comparable goods and services.[51]

a. *Relevant Geographic Market*

The parties have agreed that the relevant geographic markets in this industry are localized, and the record evidence supports that conclusion. A given bakery can provide fresh bread for only a relatively small area—swept by a radius of one hundred to two hundred miles—and competitive conditions tend to differ from one area to another.[52] Therefore, the five areas in which Continental's conduct is

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[47] *E.g., Super Turf, Inc.* v. *Monsanto Co., supra,* 660 F.2d at 1283; *Spectrofuge Corp.* v. *Beckman Instruments, Inc.,* 575 F.2d at 276; *United States* v. *Empire Gas Corp.,* 537 F.2d 296, 298–99 (8th Cir. 1976), *cert. denied,* 429 U.S. 1122 (1977); *Coleman Motor Co.* v. *Chrysler Corp.,* 525 F.2d 1338, 1348 (3d Cir. 1975); *George R. Whitten, Inc.* v. *Paddock Pool Builders, Inc.,* 508 F.2d 547, 550 (1st Cir. 1974), *cert. denied,* 421 U.S. 1004 (1974); *Mullis* v. *ARCO Petroleum Corp.,* 502 F.2d 290, 295 (7th Cir. 1974).

[48] *Grand Union Co.,* 3 Trade Reg. Rep. (CCH) ¶22,050 (July 18, 1983), at 22,702–03 [102 F.T.C. 812]; *accord, General Foods Corp., supra* note 7, ¶22,142 at 22,977–78; *Beatrice Foods Co.,* 101 F.T.C. 733, 829–30 (1983) (Douglas, Commissioner, and Miller, Chairman, concurring); *FTC Statement On Horizontal Mergers* (June 14, 1982), *reprinted in* 42 Antitrust & Trade Reg. Rep. Special Supplement (June 17, 1982) (hereinafter cited as *FTC Statement*), at (S–15)–(S–16).

[49] *Grand Union Co.,* ¶22,050 at 22,703.

[50] *Id.* at 22,703–04; *accord, FTC Statement, supra* note 48, at S–16; *Justice Department Merger Guidelines* (June 14, 1984), *reprinted in* 46 Antitrust & Trade Reg. Rep. Special Supplement (June 14, 1984) (hereinafter cited as *DOJ Guidelines*), at S–4.

[51] *Grand Union Co.,* ¶22,050 at 22,703; *accord, FTC Statement, supra* note 48, at S–15; *DOJ Guidelines, supra* note 50, at S–2. The Justice Department indicates that the test of the viability of a prospective market should be whether a hypothetical monopolist would find it profitable to impose a "small but significant and nontransitory" price increase, ordinarily to be approximated by a five percent price increase lasting one year. *DOJ Guidelines, supra,* at (S–2)–(S–3).

[52] IDF 28; *accord, ITT Continental Baking Co.,* 84 F.T.C. 1349, 1397 (1974). Continental agrees that the relevant geographic markets are local, but argues that the complaint only alleges a *nationwide* predatory campaign. However, paragraph 17 of the complaint alleges a plan "to achieve dominance . . . in all relevant geographic

(footnote cont'd)

at issue (the metropolitan areas of Denver, the Twin Cities of Minneapolis and St. Paul, Los Angeles-[34]Ventura (covering most of Southern California), and Cleveland, and the larger Northern California/Western Nevada area) should each be treated as a separate geographic market.[53]

b. *Relevant Product Market*

The Administrative Law Judge concluded that the "baking, sale and distribution of white pan bread and bread type rolls by wholesale bakers" should be treated as the relevant product market. ID at 97. However, the relevant product market should also include all white pan bread and bread type rolls produced by the captive bakeries of chain grocery stores. The record does not contain any direct evidence as to the cross-elasticities of demand and supply between white bread products produced by wholesale bakers and white bread products produced by captive bakers. However, on the demand side the record evidence does establish a high degree of competition between these two sources of white bread products.[54] The ALJ himself pointed out that "As the retail price of captive bread decreases, noncaptive chains demand lower wholesale prices for private label bread." ID at 9. [35] He also noted that "private, controlled, and secondary label breads [all of which are produced by wholesale bakers] are used by chain stores which do not have their own bakeries to compete at the retail level with the captives." IDF 36. A number of industry witnesses agreed that captive and wholesale bakers compete vigorously with one another and that their respective brands compete vigorously at the retail level,[55] and complaint counsel's own expert agreed that captives and wholesalers "compete with each other." Walsh, Tr. 8356; *but see* Tr. 8360. Furthermore, the ALJ indicated:

> Most grocers including chains who have their own bakery will usually carry a limited quantity of the advertised labels of all the wholesale bakers selling in a particular marketing area in order to meet consumer demand.

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markets;" paragraph 18 alleges an intent to "attain monopolies . . . in one or more relevant markets;" and paragraph 19(h) alleges that Continental's practices will "[i]ncrease the probability that respondents will attain a monopoly in the wholesale baking industry in each and all relevant geographic markets."

[53] The Northern California/Western Nevada market, consisting of California north of Bakersfield and south of Eureka, and the western Nevada communities of Reno, Carson City, and Lake Tahoe is considerably larger than a single metropolitan area. However, prices throughout the region appear to be relatively uniform, and the region encompasses the service areas of a number of wholesale bakers who ship products throughout the region. Continental's counsel stipulated the area as a relevant geographic market. CPF 12-14 through 12-21.

[54] The principal issue with respect to demand is whether a small change in the price of captive label white bread would induce a significant and like-signed change in the quantity of wholesale baker white bread that is demanded, and vice-versa. *FTC Statement, supra* note 48, at S-15; *Justice Department Merger Guidelines, supra*, note 50, at (S-2).

[55] Murray, Tr. 8858; Vander Giessen, Tr. 10954-57; Schaus, Tr. 11225-26; Metz, Tr. 10208-14; Nissen, Tr. 10138-39; Jakacki, Tr. 10271-73.

IDF 34. In short, captive and wholesaler bread products compete vigorously at both the wholesale and the retail level.

On the supply side, the principal issue is whether a small change in the price of wholesale baker white bread will induce a significant and opposite change in the quantity of white bread that captive bakers supply, and vice-versa.[56] That is clearly the case here. Captive bakers could readily divert production to retail grocers in response to an increase in wholesale baker [36] prices. Moreover, some retail chains could switch from purchasing white bread from wholesale bakers to producing it themselves, in their own captive bakeries.

When considered together, these factors all suggest that the relevant product market should include white bread products produced by both wholesale and captive bakers. That would be consistent with the 1984 *Justice Department Merger Guidelines,* which expressly conclude that captive production should be included in the relevant product market in merger cases when a "small but significant and nontransitory" price increase is likely to induce vertically integrated firms to increase production of the relevant product, either for outside sales or to increase their own downstream sales.[57] It would also be consistent with previous cases in which the Commission itself has recognized that wholesale and captive bakers compete with one another.[58]

2. Likelihood That Continental Would Acquire Monopoly Power

Having delineated the relevant product and geographic markets, the next step is to determine whether the conduct at issue created a dangerous probability that Continental would acquire monopoly power within those markets. A successful predatory strategy depends on the following scenario: once competition has been injured, the predator will be able to raise [37] prices to supracompetitive levels long enough to recoup losses incurred during the predatory period, and to earn greater overall profits than would have been possible from pursuing a competitive strategy.[59] A number of factors—including in particular the market power of the prospective predator, and the height of barriers to entry—affect the degree to which a given course of predatory action can be expected to result in successful monopolization.[60]

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[56] *FTC Statement, supra* note 48, at S-15; *DOJ Guidelines, supra* note 50, at S-3.

[57] *DOJ Guidelines, supra* note 50, at S-3.

[58] *Bakers of Washington, Inc.,* 64 F.T.C. 1079, 1124-25 (1964), *aff'd sub nom. Safeway Stores, Inc. et al. v. FTC,* 366 F.2d 795 (9th Cir. 1966), *cert. denied,* 386 U.S. 932 (1967); *See Flowers Industries, Inc.,* Docket No. 9148 (1980) (complaint). [102 F.T.C. 1700 (1983)]

[59] *E.g.,* Joskow and Klevorick, *A Framework For Analyzing Predatory Pricing Policy,* 89 Yale L. J. 213, 219-20 (1979).

[60] The terms "market power" and "monopoly power" are often treated as synonymous from an economic perspective. However, the term "market power" is used here to describe a whole continuum along which the power to control prices varies, beginning with the complete absence of market power at one end and ending with monopoly power at the other.

Relevant determinants of the market power of a prospective predator in this regard include its absolute and relative market shares, and those of competing firms; "the strength and capacity of current competitors; the potential for entry; the historic intensity of competition; and the impact of the legal or natural environment."[61] A firm with a large absolute share of sales in a given market will, *ceteris paribus*, find it easier to execute a successful predatory strategy than a smaller firm. Most courts have determined that market share ranging from forty percent to [38] sixty percent prior to the commencement of a predatory strategy ordinarily must be established in order to prove the requisite dangerous probability of successful monopolization.[62]

However, as the Supreme Court has recognized, focusing exclusively upon absolute market share percentages can produce a distorted view of actual market power:

> Obviously no magic inheres in numbers; "the relevant effect of percentage command of a market varies with the setting in which that factor is placed." . . . obviously, if a producer controlling an even lesser share than [the 40% share the defendant in the case controlled] is ringed by numerous smaller satellites together accounting for [39] the rest, his mastery of the market is greater than were he facing fierce rivalry of other large sellers.[63]

In this case, the record evidence indicates that it is highly unlikely that Continental could have acquired monopoly power in any of the relevant markets. As noted above, absolute and relative market share data can provide important evidence on this issue. The record does contain some useful market share data for three of the five relevant geographic markets (Denver, the Twin Cities, and Northern California/Western Nevada), and some less useful market share data for a fourth geographic market (Cleveland). These data are summarized below: [40]

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[61] *General Foods Corp., supra* note 7, ¶22,142 at 22,976.

[62] *E.g., Times-Picayune Publishing Co.* v. *United States*, 345 U.S. 594, 612–13 (1953) and n.33 (40%); *Nifty Foods Corp.* v. *Great Atlantic & Pacific Tea Co.*, 614 F.2d 832, 841 (2d Cir. 1980) (a share of 54.5% not sufficient when share fell to 33% within five years); *United States* v. *Empire Gas Co.*, 537 F.2d 296, 305 (8th Cir. 1976) (50% not necessarily sufficient, particularly in light of unreliability of data), *cert. denied*, 429 U.S. 1122 (1977); *Kearney & Trecker Corp.* v. *Giddings & Lewis, Inc.*, 452 F.2d 579, 598 (7th Cir. 1971) (33%), *cert. denied*, 405 U.S. 1066 (1972); *Lektro-Vend Corp.* v. *Vendo Co.*, 500 F.Supp. 332, 356 (N.D. Ill. 1980) (not even 50% market share in itself sufficient), *aff'd*, 660 F.2d 255 (7th Cir. 1981), *cert. denied*, 102 S.Ct. 1277 (1982); *Outboard Marine Corp.* v. *Pezetel*, 461 F.Supp. 384, 410 (D. Del. 1978) (35%); *W.L. Gore & Associates* v. *Carlisle Corp.*, 381 F.Supp. 680, 704 (D. Del. 1974) (40–60%), *aff'd in part and rev'd in part on other grounds*, 529 F.2d 614 (3d Cir. 1976); *Bowl America, Inc.* v. *Fair Lanes, Inc.*, 299 F.Supp. 1080, 1091, 1094–95 (D. Md. 1969) (in two markets: 15.5%; 33%); *Diamond International Corp.* v. *Walterhoefer*, 289 F.Supp. 550, 578 (D. Md. 1968) (share of 51% insufficient); *General Foods Corp., supra* note 7, ¶22,142 at 22,976; *E.I. du Pont de Nemours & Co.*, 96 F.T.C. 653, 725–26 n.16 (1980) (30% might in some circumstances be sufficient).

[63] *Times-Picayune Publishing Co.* v. *United States*, 345 U.S. 594, 612–13 and n.33 (1953), *quoting United States* v. *Columbia Steel Co.*, 334 U.S. 495, 528 (1948); *accord*, *American Tobacco Co.* v. *United States*, 328 U.S. 781, 796 (1946); *Pacific Coast Agricultural Export Association* v. *Sunkist Growers, Inc.*, 526 F.2d 1196, 1204–05 (9th Cir. 1975), *cert. denied*, 425 U.S. 959 (1976); *see United States* v. *Grinnel Corp.*, 384 U.S. 563, 571 (1966).

**Sales of White Bread
Products By Wholesale Bakers and
Captive Bakers In Four Markets**

Denver: 1963[64]

Firm	Share
1. King Soopers and Safeway Captive Bakeries	50.0%
2. Continental	17.5%
3. Old Homestead	14.5%
4. Campbell-Taggart	9.0%
5. Interstate	8.0%

Twin Cities: 1966[65]

Firm	Share
1. Red Owl and National Tea Captive Bakeries	30.0%
2. In-Store Bakeries of Other Firms	20.0%
3. American	15.0%
4. Continental	15.0%
5. Zinsmasters	10.0%
6. Pan O Gold	7.5%
7. Creamy Crust	2.5% [41]

N. Cal./W. Nev.: 1972[66]

Firm	Share
1. Campbell-Taggart	34.0%
2. Continental	25.5%
3. American	21.3%
4. Safeway and Lucky	15.0%
5. Inglis	4.3%

Cleveland: 1971[67]

Firm	Share
1. Pick N Pay and Fisher Fazio	50.0%
2. Interstate	-
3. Ward	-
4. American	-
5. Continental	-

The foregoing data indicate that Continental accounted for less than twenty percent of total white bread sales in the Denver and Twin Cities markets, and considerably less than thirty [42] percent of total white bread sales in the Northern California/Western Nevada market, at the respective points in time at which it began its allegedly predatory campaigns in each of those markets.[68] Those shares are considerably below the forty percent absolute market share that the courts have generally concluded must be shown, *ceteris paribus,* before a dangerous probability of success can be established. That conclusion is strengthened when Continental's share levels are considered in relative terms. In the Denver and Twin Cities markets, Continental confronted very strong competition from substantially larger captive bakery operations, as well as strong competition from one or more wholesalers of comparable size in each market. In the Northern California/Western Nevada market, Continental confronted strong competition from a substantially larger wholesaler, a wholesaler of comparable size, and three large retail chains with significant captive bakeries.

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[64] IDF 60, 61. The market share for the captive bakeries of Safeway and King Soopers is a minimum, since the ALJ indicated that "[i]n volume of white bread sales, the bakery operations of King Soopers and Safeway were larger than the combined volume of all the wholesale bakers." IDF 61 (citation omitted). Therefore, the wholesale baker market shares the ALJ cites must be reduced by at least fifty percent.

[65] IDF 111, 112. Since captive and in-store bakeries accounted for fifty percent of total white bread sales, the wholesale baker market shares the ALJ cites must be reduced by fifty percent.

[66] IDF 240, 242. These data are very approximate. The ALJ found that Safeway and Lucky together accounted for 17.8% of total white bread sales in the San Francisco/Oakland area and 11.7% of total white bread sales in the Sacramento area. IDF 242. Presumably, these figures are for their captive bakeries only, since wholesaler sales are listed separately. Since the first area is considerably larger than the second, 15% may be a roughly accurate estimate of Safeway's and Lucky's combined sales throughout the Northern California market. The share data for wholesalers that the ALJ cites should therefore be reduced by at least fifteen percent, and the chart reflects that correction. However, the wholesaler shares probably should be reduced even further to account for the captive bakery sales of Alpha Beta, another large retail chain. Unfortunately, the ALJ was apparently not able to secure market share data for Alpha Beta.

[67] IDF 296, 297. The ALJ indicates that among wholesalers, Continental was tied for third with American behind Interstate and Ward. IDF 296. Since the captive bakeries of Pick N Pay and Fischer Fazio alone accounted for fifty percent of total white bread sales to grocery stores and Kroger, A&P, and Lawsons also operated their own captive bakeries, Continental's share must not have been very large. Of course, it probably increased substantially when Continental became Pick N Pay's supplier of private label white bread. In 1969, when both wholesaler and captive bakers are included, Continental ranked second, still behind Interstate but ahead of Fisher-Fazio. IDF 342.

[68] By 1967, Continental had increased its share of total white bread sales in the Denver market to 25.6 percent at most. *See* IDF 88. This figure assumes that captive bakers still accounted for at least fifty percent of total white bread sales. That assumption seems reasonable, because wholesaler white bread dollar sales did not increase at all from 1963 through 1967. IDF 88.

The foregoing data also indicate that Continental accounted for a significantly smaller absolute share of sales in the Cleveland market (at least before Pick N Pay closed its captive bakery and began buying private label bread from Continental). As a consequence, it seems likely that Continental's absolute share of sales was considerably below the forty percent absolute market share that the courts have generally concluded must be [43] shown, *ceteris paribus,* before a dangerous probability of success can be established. Moreover, Continental confronted strong competition from two larger wholesalers and one wholesaler of comparable size.

The record apparently does not contain any evidence with which Continental's approximate share of total white bread sales in the Southern California market can be calculated. However, the ALJ did conclude that in 1974, after its allegedly predatory conduct had ended, Continental and Interstate each accounted for about forty percent of wholesaler white bread sales. IDF 225. These absolute shares would in all likelihood be reduced considerably if the white bread sales of captive bakeries—including those of Safeway, Ralph's, Von's, Lucky, Alpha Beta, Albertson's, and Certified, all large retail grocery chains —were included. *See* Vander Giessen, Tr. 10954; IDF 189. Moreover, it is important to remember that forty percent is the share of wholesale baker sales that Continental secured *after* its allegedly predatory conduct, and it is no larger than Interstate's share of sales; that hardly represents successful monopolization. Therefore, it is highly unlikely that Continental's actual share of total white bread sales, before or after its allegedly predatory conduct, satisfied the standard that most courts have endorsed.

As we noted earlier, other industry characteristics may help determine whether a given absolute and relative share of the relevant market creates a dangerous probability of monopolization. The absence of substantial entry barriers, [44] *ceteris paribus,* is particularly likely to eliminate that probability. Barriers to entry must be substantial for a predatory strategy to succeed. Otherwise, when the predator attempts to raise prices to supracompetitive levels after the predation period, new firms will enter and/or terminated firms will reenter and force the predator to lower its prices to competitive levels.[69] The Commission has defined entry barriers as "substantial non-recurring outlays" that raise the entry costs of potential entrants sufficiently high to permit incumbent firms to restrict output and raise prices for a significant period of time.[70] Governmental restrictions may also create partial or absolute barriers to entry.

The record evidence indicates that barriers to entry into the bread baking industry are not particularly high. Three potential barriers to entry have been suggested in this industry. First, complaint counsel argue that the difficulty of acquiring retail shelf space for new bread products makes entry difficult. CAB at 21. This does not appear likely, because it assumes that retail grocers cannot easily adjust the size of their bakery sections to include promising new brands, and that any given prospective entrant will not be able to secure shelf space in any retail grocery outlets. The record does not contain any significant evidence to support these assumptions. **[45]**

Second, the ALJ has suggested that making expenditures associated with developing a franchise for advertised label bread represents a barrier to entry. It is true that product differentiation may in some circumstances represent such a barrier. However, as noted above, the Commission has determined that product differentiation should be treated as a barrier to entry only if it makes new entry contingent upon non-recurring outlays substantial enough to permit incumbent firms to restrict output and raise prices for a significant period of time.[71] In this case, that condition is not satisfied because private label and captive label breads—which do not ordinarily require more than minimal promotional support—have been and continue to be both successful and a significant constraint upon advertised label bread sales.

Third, the ALJ has suggested that "the propensity of the large multi-plant companies to engage in below cost pricing" represents a barrier to entry. ID at 92. However, there is little in the record to suggest that multiplant economies of scale, or any other technological factors, for that matter, deter entry. *See, e.q.,* Jakacki, Tr. 10282. In any event, allegations of predatory pricing represent the central issue in this case, and we conclude in Part III.D. below that Continental's pricing behavior did not violate the Commission's predatory pricing standard. **[46]**

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[69] Joskow and Klevorick, *supra* note 59, at 227.

[70] *General Foods Corp., supra* note 7, ¶22,142 at 22,981, *citing* R. Posner, *Antitrust Law: An Economic Perspective* 59 (1976). Relevant entry costs may include production, distributional and promotional expenses.

[71] *General Foods Corp., supra* note 7, ¶22,142 at 22,981.

The market share data developed above, in conjunction with the absence of any countervailing industry characteristics, persuade us that even if Continental had made sales at prices below average variable cost in some areas for a significant period of time, such pricing behavior could not have created a dangerous probability that Continental would acquire monopoly power in any of the relevant markets. Since establishing a dangerous probability of success is an essential element of the attempted monopolization offense, the Commission has therefore determined to reverse the ALJ and dismiss that portion of the complaint. [47]

III. SECTION 2(a) OF THE CLAYTON ACT

Section 2(a) of the Clayton Act, as amended by the Robinson-Patman Act, provides

> That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them. . . .[72]

In this case, Count II of the complaint alleges that Continental discriminated

> in price, directly or indirectly, between different purchasers of bread, by selling bread of like grade and quality to some of such purchasers at substantially higher prices than to other of such purchasers.

This allegation has evolved into two more specific allegations: (1) that Continental sold its advertised label bread, secondary label bread, and/or private label bread at different prices to some purchasers than to others in all five relevant geographic [48] markets; and (2) that Continental sold its private label hot dog and hamburger buns at higher prices to some purchasers than to others in the Cleveland market. This part of the opinion evaluates these allegations.[73]

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[72] 15 U.S.C. 13(a). Section 2(a) also includes a cost justification defense, and several other miscellaneous provisions.

[73] In *General Foods Corp.*, the Commission concluded that it did not need to determine whether General Foods' conduct satisfied the jurisdictional and predatory pricing components of a Section 2(a) violation because it was "unable to find *any* prospect of injury to competition from the events described in [the] record." *General Foods Corp., supra* note 7, ¶22,142 at 22,988 (emphasis added). The Commission determined that the relevant markets at issue were larger than the sales districts that complaint counsel had alleged, and that because complaint counsel

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A. *Preliminary Jurisdictional Issues*

Like other parts of the Clayton Act, Section 2(a) includes a variety of jurisdictional requirements that must be satisfied before the substantive prohibitions of the subsection apply. One commentator has summarized these jurisdictional requirements in the following fashion: **[49]**

> In order to bring the substantive portions of the Act into play, there must be (1) two or more consummated sales, (2) reasonably close in point of time, (3) of commodities, (4) of like grade and quality, (5) with a difference in price, (6) by the same seller, (7) to two or more different purchasers, (8) for use, consumption, or resale within the United States or any territory thereof, (9) which may result in competitive injury. Furthermore, (10) the "commerce" requirement must be satisfied. All ten of these jurisdictional elements must be met in order to invoke the power of the Federal Trade Commission or the courts to consider the lawfulness of pricing transactions.[74]

Seven of these requirements—all except the "like grade and quality," commerce, and competitive injury requirements—are not in dispute, and the evidence supports concluding that they have been satisfied in each of the five relevant geographic markets. In each of these markets, Continental made at least two sales—reasonably close in time—of commodities at different prices to two or more different purchasers "for use, consumption, or resale within the United States." At certain times from 1964 through 1969 in the Denver market, Continental sold private label bread from its Denver bakery (under the "Tender Crust" label) to Associated Grocers at prices that were typically between one cent and three cents lower per one-pound loaf than the prices it charged other purchasers for its advertised label Wonder Bread **[50]** products.[75] At certain times from 1966 through 1968 in the Twin Cities market, Continental sold Wonder Bread, secondary label bread (under the "Wonder Country Style" label) and private label bread from its Minneapolis bakery at different prices to different purchas-

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had not alleged any larger markets, the Commission was "constrained on review from finding that respondent attempted to monopolize some larger market." *Id.* at 22,982 and n.56. Hence, even if General Foods had controlled one hundred percent of sales in one of its sales districts, the Commission concluded that it would not have possessed monopoly power, because firms outside the district would have constrained that power. *Id.* at 22,983. Moreover, the Commission found that competition in the ground coffee industry was "healthy and virtually invulnerable to the assaults of any one firm. . . ." and concluded: "Healthy competition does not violate the Robinson-Patman Act." *Id.* at 22,988–89. In short, the Commission concluded that there was *no* reasonable possibility that price differences charged by General Foods could injure competition. *Id.* at 22,988, *citing Falls City Industries, Inc.* v. *Vanco Beverage, Inc.*, 103 S.Ct. 1282, 1288 (1983). In this case, by contrast, the relevant product and geographic markets are well defined, and the record evidence does not permit us to conclude that competition within these markets is so vigorous that *no* reasonable possibility of harm to competition from discriminatory pricing could be established.

[74] E. Kintner, *A Robinson-Patman Primer* 35 (2d ed. 1979); *accord*, L. Sullivan, *Handbook of the Law of Antitrust* 679–80 (1977).

[75] ID at 82; IDF 66, 67, 83. Continental's contracts with Associated Grocers during this period required its Tender Crust wholesale price to be at least one cent lower than its Wonder Bread wholesale price. IDF 78.

ers.[76] At certain times from 1970 through 1973 in the Southern California market, Continental sold private label bread to several retail grocery chains at prices lower than those it charged other purchasers for Wonder Bread. IDF 217. At certain times between 1972 and 1974 in the Northern California market, Continental sold private label bread from its San Francisco Bay Area bakeries to several retail grocery chains, at lower prices than it charged other purchasers for Wonder Bread.[77] Finally, during 1973 and 1974 in the Cleveland market, Continental sold private label bread from its Akron bakery to Pick N Pay (hereinafter "PNP"), a large local retail grocery chain, at prices that were lower than those it charged other purchasers for Wonder Bread from its Akron bakery. IDF 311, 328, 329, 338. At certain times during that period, it also charged PNP lower prices for private label hot dog and hamburger buns than it charged other purchasers. IDF 311, 332, 339, 353, 356. [51]

As the foregoing analysis suggests, Continental charged different prices for private label and advertised label bread products in each of the five relevant geographic markets, and its conduct consequently satisfies seven of the ten jurisdictional requirements.[78] The three disputed jurisdictional issues are discussed below.

B. *The Like Grade and Quality Requirement*

One might reasonably argue that private label and advertised label bread products are not "commodities of like grade and quality" because the advertised label bread products consistently sell at a higher price than their physically identical private label counterparts. *See* IDF 36. That persistent price differential indicates that consumers perceive some differences in quality between advertised label and private label bread products, suggesting in turn that the cross-elasticity of demand between the two may not be extremely high. Moreover, although the cross-elasticity of supply between private label and advertised label bread is high at the production level, it is probably considerably lower at the distribution level because the sale of advertised label bread typically requires substantial [52] promotional efforts not needed to sell private label bread.[79] However, the Supreme

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[76] IDF 106, 118, 120, 121, 125, 128–130.

[77] IDF 231, 233, 249, 258, 263, 272–278. These data exclude November, 1972–January, 1973, when Continental's bakeries were closed by a labor strike. IDF 260; CPF 12–79.

[78] Continental argues that in primary line cases "the lower price must be shown to have been subsidized, made possible, by the higher price." RAB at 30. However, the Supreme Court has indicated that a price discrimination "is merely a price difference," without incorporating a subsidization requirement. *FTC* v. *Anheuser-Busch, Inc.*, 363 U.S. 536, 549 (1960); *accord, William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d at 1040.

[79] This does not mean that private label and advertised label bread should not be treated as part of the same relevant product market, for purposes of the Sherman Act. The fact that two items command different prices does not necessarily establish that they are different products. The key issue is whether cross-elasticities of demand and supply are sufficiently high to make the prices of the two items substantially interdependent. The record evidence indicates that cross-elasticities of demand and supply between advertised label and private label bread products are sufficiently high to make them part of the same product market. Indeed, the ALJ pointed out:

(footnote cont'd)

Court has determined that physically identical private label and advertised label products—regardless of distributional differences—should be treated as commodities of "like grade and quality" under the Clayton Act. In *FTC* v. *Borden* the Court rejected Borden's claim that private label and Borden-brand evaporated milk—otherwise indistinguishable—should be treated as different "grades" because the Borden brand regularly sold at a higher price than the private label [53] brand.[80] The Court determined that since the two products were "physically and chemically identical," they were of like grade and quality, despite their persistently different prices.[81] The Commission has therefore determined to treat advertised label and private label bread products as commodities of "like grade and quality."

C. *The Commerce Requirement*

The commerce requirement can be broken down into three distinct segments. First, the "person" involved must be "engaged in commerce." Second, the price discrimination alleged must occur in the course of such commerce.[82] Third, at least one of the sales that create the alleged price discrimination at issue must be "in interstate commerce,"[83] although it does not matter whether the sale at the higher price or the sale at the lower [54] price moves across a state line.[84] If the third requirement can be satisfied, then the first two requirements must necessarily also be satisfied.[85]

The courts have interpreted the commerce requirement differently in primary line and secondary line Section 2(a) cases. In primary line cases, it is sufficient to establish that the seller made sales at different prices in two or more states, even though the areas in which the discriminatory sales were made are not part of the same geographic market. In *Moore* v. *Mead's Fine Bread Co,* the Supreme Court noted that the defendant sold bread it manufactured in New Mexico to

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> A large retail price spread between captive and private label bread, on the one hand, and the advertised label bread, on the other, will result in a loss of sales of advertised label bread. If this price spread is reduced the captive and private label products will lose sales and there will be an increase in sales of advertised label bread.

IDF 36; *accord,* Nissen, Tr. 10139; Metz, Tr. 10239–40. In short, as the price differential increases or declines, the quantity of private label bread products demanded will respectively increase or decline. However, it is important to recognize that advertised label bread and private label bread are not *identical* products; they are differentiated in the minds of consumers to a significant degree.

[80] *FTC* v. *Borden Co.,* 383 U.S. 637, 640, 645–46 (1966).

[81] *Id.* at 638, 640. Real differences in quality may of course place products in different "grades." *Id.* at 644 n.5.

[82] *Standard Oil Co.* v. *FTC,* 340 U.S. 231, 236-38 (1951).

[83] *Gulf Oil Corp.* v. *Copp Paving Co.,* 419 U.S. 186, 195 (1974). By contrast, the Federal Trade Commission Act applies to unfair methods of competition "in *or affecting* commerce." 15 U.S.C. 45(a)(1) (emphasis added).

[84] *Moore* v. *Mead's Fine Bread Co.,* 348 U.S. 115, 119 (1955); *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.,* 668 F.2d 1014, 1043–44 (9th Cir.), *cert. denied,* 103 S.Ct. 57 (1982). We do not need to determine whether *de minimis* interstate sales are sufficient to satisfy this jurisdictional requirement because Continental's sales at different prices were significant in each of the relevant markets. *Compare William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.,* 668 F.2d at 1044 and n.54 *with Food Basket, Inc.* v. *Albertson's Inc.,* 383 F.2d 785, 788 (10th Cir. 1967).

[85] *See, e.g., Lehrman* v. *Gulf Oil Corp.,* 464 F.2d 26, 36–37 (5th Cir.), *cert. denied,* 409 U.S. 1077 (1972); *Liquilux Gas Servs., Inc.* v. *Tropical Gas Co.,* 303 F.Supp. 414, 416–17 (D. P.R. 1969).

customers in Texas at a price higher than the price it charged to certain customers in New Mexico.[86] As a consequence, the Court determined that the primary line discrimination alleged in the complaint satisfied the [55] commerce requirement of Section 2(a).[87] A number of courts have more recently taken the position, however, that the discriminatory sales at issue must originate from the same plant. In *Willard Dairy* v. *National Dairy*, the Sixth Circuit concluded that Section 2(a) did not apply to allegedly predatory sales in Willard, Ohio by an interstate defendant because the plant that the defendant used to supply the Willard area was used only for intrastate sales; the defendant did not sell wholesale milk from that plant in any other state.[88] The court pointed out that

> the fact that the defendant also made interstate shipments from *other* than its Shelby, Ohio plant to areas in which the plaintiff did not engage in business is immaterial to the issue in the case.[89] [56]

These cases establish that in order to satisfy the commerce requirement in a primary line case, the defendant that makes the allegedly discriminatory sales at issue in one state must also make sales of the same product from the same plant in other states.[90]

In this case, the commerce requirement is satisfied—for primary line purposes—in each of the relevant geographic markets. In the Denver market, Continental's Denver bakery produced both the private label bread that it sold to Associated Grocers (with members in five different states) and the advertised label Wonder Bread that it sold to retailers in Colorado, Wyoming, and Nebraska. IDF 53–55, 57. In the Twin Cities market, Continental's Minneapolis bakery produced both the private label bread sold to three large chain stores and the Wonder Bread and Wonder Country Style bread sold to other retailers in Minnesota and Wisconsin. IDF 103, 106. It also supplied the Continental bakery in Rochester with bakery products that were in turn shipped to other Minnesota and Wisconsin communities. IDF 103–104. In the Southern California market, Continental's Beverly Hills and DiCarlo (San Pedro) bakeries produced both the private label bread sold to large retail chains and the advertised label bread sold to other retailers, including [57] bread that was sold and delivered—through Continental's San Diego bakery—to customers in Arizona. IDF 177, 179, 201, 217. In the Northern California/Western Nevada market, Continental's San Francisco Bay Area bakeries produced both the private label bread sold to several chain grocery stores (some with stores in both California and Nevada) and the advertised label bread sold to other retailers.[91] Finally, in the Cleveland market, Continental's Akron bakery produced both the private label bread sold to PNP in the Cleveland area, and the Wonder Bread and Wonder Country Style Bread sold to customers in both Ohio and [58] Pennsylvania.[92] As a consequence, the commerce requirement for primary line jurisdiction is satisfied in all five relevant geographic markets.[93] [59]

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[86] *Moore* v. *Mead's Fine Bread Co.*, 348 U.S. at 116–17.

[87] Respondent argues that the commerce requirement cannot be satisfied because the discriminatory sales allegedly injured competition only within the relevant geographic markets. RAP at 31. However, that is not the standard the Supreme Court has adopted in primary line cases. It is enough simply to show that some of the sales from a given plant were made at different prices in different states.

[88] *Willard Dairy Corp.* v. *National Dairy Products Corp.*, 309 F.2d 943, 946 (6th Cir. 1962), *cert. denied*, 373 U.S. 934 (1963).

[89] *Id.; accord*, *Borden Co.* v. *FTC*, 339 F.2d 953, 955 (7th Cir. 1964); *Beatrice Foods Co.*, 76 F.T.C. 719, 822 (1969), *aff'd sub nom. Kroger Co.* v. *FTC*, 438 F.2d 1372 (6th Cir.), *cert. denied*, 404 U.S. 871 (1971).

[90] This suggests that an interstate firm may be able to avoid the primary line proscriptions of Section 2(a) by using a local plant that sells its products solely intrastate. Kintner, *supra* note 74, at 95; *see Bacon* v. *Texaco, Inc.*, 503 F.2d 946, 948–49 (5th Cir. 1974) (*per curiam*), *cert. denied*, 420 U.S. 1005 (1975); *Kane* v. *Martin Paint Stores, Inc.*, 1974-2 Trade Cas. (CCH) ¶75,296 (S.D.N.Y. 1974), at 97, 914–15.

The commerce requirement for secondary line cases is more restrictive. In *Mayer Paving* v. *General Dynamics,* the Seventh Circuit concluded that in determining whether "either or any" discriminatory sale is in commerce, only the purchases of the allegedly injured purchaser and its competitors can be considered.[94] The Court pointed out that

> to the extent customers on different sides of a boundary line do not compete with each other, no adverse competitive effects on the customer level can ensue from the supplier's price variations.[95]

The Court distinguished this conclusion from the Supreme Court approach in primary-line cases by noting that injury to competition among *sellers* may arise if the discriminating seller can subsidize its lower prices for product from a given plant in one state with higher prices for product from that same plant in other states. By contrast, injury to competition among *buyers* may arise only if the favored and disfavored buyer(s) compete with one another in a relevant geographic market.[96] In short, secondary line injury cannot be established—because the jurisdictional commerce requirement cannot be satisfied—in any relevant secondary line geographic market that does not cross [60] state lines, because by definition favored buyers in that market do not compete with disfavored buyers in other markets.[97]

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[91] IDF 229, 231–33; *accord, William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d at 1044. Continental operated bakeries in San Francisco, Oakland and Sacramento. However, their output is considered collectively because each bakery supplied bread products to—and transshipped bread products through—each of the others. IDF 231.

[92] IDF 285–287, 347; CPF 13–126, 13–143 through 13–145, 13–147, 13–148. Although Continental did not ship Wonder Bread directly from the Akron bakery to retailers in other states, the Akron bakery supplied the Youngstown bakery with Wonder bread on a daily basis, and Youngstown in turn sold that bread daily to retailers in both Ohio and Pennsylvania. As long as the practical economic continuity of the interstate sales are unbroken—that is, the goods are shipped in a completely unchanged state, with no hiatus for repacking or warehousing—sales such as these satisfy the "in commerce" requirement. *Compare Belliston* v. *Texaco, Inc.*, 455 F.2d 175, 178–80 (10th Cir.) (interstate shipment of crude oil not sufficient to place sales of gasoline refined from crude oil in interstate commerce), *cert. denied,* 408 U.S. 928 (1972); *L.M.T., Inc.* v. *House of Sobel,* 1979-2 Trade Cas. ¶62,817 (N.D. Cal. 1979) ("practical economic continuity" not maintained where defendants ordered liquor for general inventory, rather than to meet the needs or orders of specific customers) *with Foremost Dairies, Inc.* v. *FTC,* 348 F.2d 674, 677–78 (5th Cir.), *cert. denied,* 382 U.S. 959 (1965) (milk passed in "steady flow" from Colorado farms through Santa Fe processing plant to retail grocery stores in Albuquerque). I am indebted to Commissioner Bailey for this point.

[93] The Commission does not accept the ALJ's conclusion that all of Continental's sales—including the allegedly discriminatory sales—are in commerce because all local grocery chains negotiate their bread purchases with a "corporation located in New York." ID at 80. As the Commission has indicated previously, "Interstate negotiation . . . alone is insufficient to fulfill the commerce requirement of the Robinson-Patman Act . . ." *Beatrice Foods Co.*, 76 F.T.C. at 822; *accord, Borden Co.* v. *FTC,* 339 F.2d 953, 955 (7th Cir. 1964).

[94] *Mayer Paving & Asphalt Co.* v. *General Dynamics Corp.*, 486 F.2d 763, 769 (7th Cir. 1973), *cert. denied,* 414 U.S. 1146 (1974); *accord, McGoffin* v. *Sun Oil Co.*, 539 F.2d 1245, 1248 (10th Cir. 1976); *Myers* v. *Shell Oil Co.*, 96 F.Supp. 670, 675–76 (S.D. Cal. 1951); *Beatrice Foods Co.*, 76 F.T.C. at 822.

[95] *Mayer Paving & Asphalt Co.* v. *General Dynamics Corp.*, 486 F.2d at 770, *quoting* F. Rowe, *Price Discrimination Under the Robinson-Patman Act* 179 (1962).

In this case, allegations of secondary line violations of Section 2(a) extend only to the Northern California/Western Nevada market and the Cleveland market. Of course, the relevant geographic markets for secondary line retail grocery sales are considerably smaller than the relevant geographic markets for primary line wholesale and captive bakery sales. The Commission has used Standard Metropolitan Statistical Areas (SMSAs) as a good approximation of relevant geographic markets in a number of recent retail grocery store merger cases.[98] At least one retail grocery market in the Northern California/Western Nevada area satisfies the commerce requirement, because disfavored retailers in Reno and Sparks, Nevada that purchased Wonder bread products from Continental arguably competed with favored retailers in California that purchased private label bread products from [61] Continental.[99] However, the second market, the Cleveland retail grocery market, does not satisfy the secondary-line commerce requirement, because it does not include any areas outside Ohio. The Cleveland SMSA consists of Cuyahoga, Lake, Medina and Geauga Counties, all of which lie within the confines of the state of Ohio. CPF 13–32. Moreover, the market area of PNP, the retail grocer that allegedly received lower prices, apparently does not extend beyond greater Cleveland, so that PNP does not compete with any retailers located outside Ohio. RRB at [62] 28; *see* CX 992–E. Therefore, the allegation of secondary line discrimination in Cleveland must be dismissed because it does not satisfy the "in commerce" jurisdictional requirement.[100]

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[96] *Id.*

[97] *Falls City* v. *Vanco* is not inconsistent with this conclusion. There, the District Court had concluded that although the two buyers involved could not sell to the same retailers, they nevertheless competed with one another because the relevant geographic market at *retail* included both the Indiana county and the Kentucky county involved. *Falls City Industries, Inc.* v. *Vanco Beverage, Inc.*, 103 S.Ct. 1282, 1287 (1983).

[98] *E.g., Grand Union Co.*, 3 Trade Reg. Rep. (CCH) ¶22,050 (July 18, 1983), at 22,708; *Albertson's, Inc.*, 97 F.T.C. 343, 345 (1981) (allegation in complaint issued with consent); *Godfrey Co.*, 97 F.T.C. 456, 458 (1981) (allegation in complaint issued with consent).

[99] CPF 12–125 through 12–129; CPF 12–187 through 12–201. The relevant retail grocery market arguably includes both the Nevada communities of Reno, Sparks, and Lake Tahoe and the California Lake Tahoe area.

D. *The Injury To Competition Requirement.*

In order to establish the injury to competition component of a Section 2(a) violation, the Commission must establish that the price discrimination at issue may substantially "lessen competition or tend to create a monopoly in any line of commerce." 15 U.S.C. 13(a). More precisely, this implies that the Commission must establish a "reasonable possibility that a [63] price difference may harm competition."[101] The injury to competition standards in primary line and secondary line cases differ, however, and we must therefore discuss the allegations of primary line and secondary line injury separately.

1. Primary Line Injury

In order to establish primary-line injury, complaint counsel must establish that the price differences at issue either injured or threatened to injure competition at the primary level; that is, among competing sellers.[102] That showing may be effected either (1) by means of a detailed market analysis establishing that the discrimination at issue actually injured competition or (2) by establishing predatory intent, from which competitive injury may be inferred.[103] Under the first approach, it is not enough simply to establish that individual sellers have been [64] injured, or that some competitors have left the market.[104] Direct evidence that competition among sellers has been injured[105] must be developed.[106] Under the second approach, in lieu of direct evidence of anticompetitive effects, the Commission must establish injury to competition by rebuttable inference from predatory intent, which can in turn be established either directly or by rebuttable inference from predatory [65] conduct.[107] When predatory intent or predatory pricing are relied upon to establish primary line injury to competition in violation of Section 2(a), the standards that govern the intent and conduct components of the attempted monopolization offense should apply.[108] For example, the Ninth Circuit has concluded that where [66]

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[100] Since Section 5 of the Federal Trade Commission Act can be used to fill inadvertent gaps in the coverage of the Robinson-Patman Act—to an extent consistent with the "spirit" of that Act—it might be possible for the Commission to apply the more expansive jurisdictional coverage of primary line cases to secondary line cases. There are at least two reasons not to take that approach. First, the more restrictive approach is more consistent with economic theory in this case. Grocery retailers compete with one another in SMSA markets, and a pair of discriminatory prices can therefore injure disfavored retailers only if sales at both prices in the pair are made in the same SMSA. Second and more generally, the Commission has concluded that

> unlike the Sherman and Clayton Acts, the underlying goal of the Robinson-Patman Act is the protection of competitors, not competition. Accordingly, the "spirit" theory must be applied with great caution in the context of cases brought under that Act.

General Motors Corp., 3 Trade Reg. Rep. (CCH) ¶22,165 (June 21, 1984), at 23,023. [103 F.T.C. 641]

[101] *Falls City Industries, Inc.* v. *Vanco Beverage Co.*, 103 S.Ct. 1282, 1288 (1983); *accord, Corn Products Refining Co.* v. *FTC*, 324 U.S. 726, 742 (1945). Complaint counsel need not show that the discriminations alleged actually injured competition. *J. Truett Payne Co.* v. *Chrysler Motors Corp.*, 451 U.S. 557, 562 (1981).

[102] *Double H Plastics, Inc.* v. *Sonoco Products Co.*, 5 Trade Reg. Rep. (CCH) ¶65,949 (3d Cir. April 20, 1984), at 68,102; *O. Hommel Co.* v. *Ferro Corp.*, 659 F.2d 340, 346 (3d Cir. 1981), *cert. denied*, 455 U.S. 1017 (1982).

[103] *Double H Plastics* v. *Sonoco*, ¶65,949 at 68,102; *D.E. Rogers Associates, Inc.* v. *Gardner-Denver Co.*, 718 F.2d at 1439; *O. Hommel Co.* v. *Ferro Corp.*, 659 F.2d at 347; *Pacific Engineering & Prod. Co.* v. *Kerr-McGee Corp.*, 551 F.2d 790, 798 (10th Cir.), *cert. denied*, 434 U.S. 977 (1977); *National Dairy Products Corp.* v. *FTC*, 412 F.2d 605, 612–13 (7th Cir. 1969); *Beatrice Foods Co.*, 76 F.T.C. at 799.

[104] *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d at 1042 (the fact that the plaintiff suffered losses and eventually ceased operations is not enough to establish a Section 2(a) violation); *O. Hommel Co.* v. *Ferro Corp.*, 659 F.2d at 347; *International Air Industries, Inc.* v. *American Excelsior Co.*, 517 F.2d 714, 721–22 (5th Cir. 1975), *cert denied*, 424 U.S. 943 (1976); *Anheuser-Busch, Inc.* v. *FTC*, 289 F.2d 835, 840 (7th Cir. 1961) (other competitors losing market share does not demonstrate injury); *General Foods Corp., supra* note 7, ¶22,142 at 22,989 and n.76 (Commission Opinion), 22,992 (Bailey, Commissioner, concurring); *Beatrice Foods Co.*, 76 F.T.C. 719, 800 (1969), *aff'd sub nom. Kroger Co.* v. *FTC*, 438 F.2d 1372 (6th Cir.), *cert. denied*, 404 U.S. 871 (1971); *Lloyd A. Fry Roofing Co.*, 68 F.T.C. 217, 260 (1965), *aff'd*, 371 F.2d 277 (7th Cir. 1966).

> a price differential threatens a primary line injury, . . . Section 2 of the Sherman Act . . . and Section 2(a) of the Clayton Act . . . are directed at the same economic evil and have the same substantive content . . .[109]

The record does not contain any direct evidence suggesting that Continental's behavior injured competition. It is true that a number of bakeries, including Laub in Cleveland, Old Homestead in Denver, and Inglis in northern and southern California exited their respective markets at some point during the corresponding relevant time period. However, there is little evidence to the effect that these exits were occasioned by Continental's behavior, rather than by poor management, inefficiency, an overall reduction in the demand for white bread, or other unfortunate but nevertheless perfectly competitive explanations. Moreover, even if the exit of one or more of these bakers could be attributed to the conduct of Continental, that would not be sufficient to establish the requisite injury to competition unless Continental's behavior could be characterized as predatory or otherwise anticompetitive. Vigorous, legitimate competition forces less efficient firms to exit constantly; that in fact is a frequent consequence of vigorous competition.

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[105] The "substantial lessening of competition" component of a Section 2(a) offense may be somewhat easier to satisfy than the "dangerous probability of successful monopolization" requirement for proving attempted monopolization under the Sherman Act. *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d at 1042. However, when *no* showing of predatory conduct can be made it is highly unlikely that the Section 2(a) injury to competition requirement can be satisfied by direct evidence. *Id.; Anheuser-Busch* v. *FTC*, 289 F.2d at 843–44.

[106] For an example where the Commission determined that *no* reasonable possibility of injury to competition existed, *see* noted 73, *supra*.

[107] *O. Hommel Co.* v. *Ferro Corp.*, 659 F.2d at 347; *Janich Bros.* v. *American Distilling Co.*, 570 F.2d 848, 855 (9th Cir. 1977), *cert. denied*, 439 U.S. 829 (1978); *Beatrice Foods Co.*, 76 F.T.C. 719, 799–800 (1969), *aff'd*, 438 F.2d 1372 (6th Cir.), *cert. denied*, 404 U.S. 871 (1971). As the Ninth Circuit has pointed out, however,

> *direct* evidence of intent alone can be ambiguous and misleading. . . . Especially misleading here is the inveterate tendency of sales executives to brag to their superiors about their competitive prowess, often using metaphors of coercion that are compelling evidence of predatory intent to the naive. Any doctrine that relies upon proof of intent is going to be applied erratically at best.

William Inglis & Sons Baking Co. v. *ITT Continental Baking Co.*, 718 F.2d at 1028 and n.6 (emphasis added).

[108] *D.E. Rogers Associates, Inc.* v. *Gardner-Denver Co.*, 718 F.2d at 1439; *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d at 1041–42; *O. Hommel Co.* v. *Ferro Corp.*, 659 F.2d at 348; *Janich Bros., Inc.* v. *American Distilling Co.*, 570 F.2d 848, 855 (9th Cir. 1977), *cert. denied*, 439 U.S. 829 (1978); *Pacific Engineering & Production Co.* v. *Kerr-McGee Corp.*, 551 F.2d 790, 798–99 (10th Cir.), *cert. denied*, 434 U.S. 879 (1977); *International Air Industries* v. *American Excelsior Co.*, 517 F.2d 714, 720 n.10 (5th Cir. 1975), *cert. denied*, 414 U.S. 975 (1976).

[109] *Janich Bros., Inc.* v. *American Distilling Co.*, 570 F.2d at 855.

We must therefore determine whether the requisite injury to competition may be inferred from Continental's pricing behavior. We have already determined that sales at prices equal to or greater than average variable cost will be strongly [67] presumed to be legitimate, and that sales at prices below average variable cost will be presumed to be predatory. This standard should apply to defining predation under Section 2(a) of the Clayton Act, as well as to satisfying the specific intent and anticompetitive conduct components of the attempted monopolization offense under Section 2 of the Sherman Act. Therefore, sales at prices that equal or exceed average variable cost cannot ordinarily satisfy the predation element of primary line injury to competition under Section 2(a).[110]

The first step in such an analysis must necessarily be to determine the contours of the product that Continental allegedly sold at prices below average variable cost. Professor Areeda has recently argued that in determining whether one should consider the prices and costs associated with a single product, or those associated with an entire line of products, the crucial issue should be the contours of the product or line that rival firms can sell. When competing firms can sell the same line of products that the alleged predator can sell, selling a single product in that line at prices below average variable cost cannot exclude equally efficient competing firms, which can match those prices as long as overall revenues exceed the variable costs [68] associated with the product line as a whole.[111] In this case, the instrument of predation should be defined at least broadly enough to include the full line of private label white pan bread products that Continental sold in each market. As Continental has pointed out, "[r]etailers do not buy, and wholesalers do not sell, simply one item in a line."[112] As a consequence, if a wholesaler wishes to supply private label bread to a given retailer, it typically must supply an entire line of white bread products, including the most popular loaf sizes and hamburger and hot dog rolls. The record evidence does not establish that competing bakers could not, like Continental, produce an entire line of private label white pan bread products. Therefore, to the extent that an entire line of white bread constitutes the minimum product offering necessary for a baker to stay in business, only prices that cause revenue to fall below variable cost for the entire line could conceivably force equally efficient competitors out of business.

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[110] *D.E. Rogers Associates, Inc. v. Gardner-Denver Co.*, 718 F.2d at 1439; *O. Hommel Co. v. Ferro Corp.*, 659 F.2d at 349–50; *Pacific Engineering & Prod. Co. v. Kerr-McGee Corp.*, 551 F.2d 790, 797–98 (10th Cir.), *cert. denied*, 434 U.S. 879 (1977); *see International Air Industries, Inc. v. American Excelsior Co.*, 517 F.2d 714, 724 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976).

[111] P. Areeda, *Antitrust Law Supplement* 145–46 (1982).

[112] RAP at 33, *citing* Biechner, Tr. 3553–54, Jones, Tr. 3700.

The case law supports considering at least the whole line of private label white bread sales in the aggregate. In *Janich* v. *American Distilling*, the Ninth Circuit considered allegations that the defendant had attempted to monopolize the sale of private label gin and vodka in California, and had sold gin and **[69]** vodka of like grade and quality at discriminatory prices.[113] The Court of Appeals determined that whether the defendant sold gin and vodka at predatory rices should be determined by considering its prices and costs for its full line of gin and vodka products, rather than simply its half gallon sizes of gin and vodka.[114] The Court indicated that

> [t]he product must be such that if predatorily priced, rivals are likely to be driven out of the market or excluded, allowing the firm to raise prices. . . .[115]

A strong argument can be made, however, that the instrument of predation in this case should be defined more broadly, to include both advertised label and private label white pan bread products. The relevant product market includes both advertised label and private label bread products, because the cross-elasticity of supply between them is relatively high, and the cross-elasticity of demand between them is at least somewhat significant. Moreover, the Supreme Court determination that physically identical private label and advertised label products should be considered to be of "like grade and quality" requires **[70]** us to treat advertised label and private label white pan bread as commodities of like grade and quality in satisfying that jurisdictional requirement of the Clayton Act.

Defining the instrument of predation to include both advertised label and private label white pan bread products would be consistent with the determination that the instrument of predation should encompass the product or line of products that rival firms can sell. The record evidence indicates that almost all of the major wholesale bakers in the five relevant geographic markets, including the firms that exited those markets during the relevant time periods (Old Homestead in Denver, Prosser and Gordon in Southern California, and Inglis in Northern California/Western Nevada), marketed an advertised label white pan bread product, and nearly as many marketed private label bread as well.[116] The record evidence confirms that a wholesaler that produces private label bread for a given retailer almost always makes substantial sales of its advertised label bread as a part of the deal. Continental argues that increased advertised label sales are "an essential ingredient of any private label transaction;" that it sells "a [71] bread line of various items at different prices under two labels," and assesses profitability on a full line basis; and that "the composite price of the entire line" is the relevant price.[117] In Denver, for example, as complaint counsel themselves indicate, Continental expected to make substantial Wonder bread sales through Associated Grocers retailers as a consequence of its Tender Crust private label program for those grocers. CAB at 54, *citing* L. Johnson, Tr. 7201, CX 1522 D–E. Therefore, it may be perfectly logical for a firm like Continental to sell private label and advertised label bread as a package, offsetting lower prices for and profits from private label bread with higher prices for and profits from greater advertised label bread sales. In fact, Continental argues that if it were to refuse to sell private label products at prices below full cost, its advertised label sales would decline. RAP at 26. As a result, even if prices for Continental's private label bread did not always cover the variable costs associated with private label sales, that arguably should not be considered predatory unless those losses were sufficiently high to push overall revenues—including advertised label revenues—below variable cost.

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[113] *Janich Bros., Inc.,* v. *American Distilling Co.,* 570 F.2d 848, 852 (9th Cir. 1977), *cert. denied,* 439 U.S. 829 (1978).

[114] *Id.* at 856; *accord, ILC Peripherals* v. *International Business Machines,* 458 F.Supp. 423, 433 (N.D. Cal. 1978), *aff'd,* 636 F.2d 1188 (9th Cir. 1980), *cert. denied,* 452 U.S. 972 (1981). The opinion in *Janich* does not indicate whether the defendant sold branded gin and vodka, as well as private label gin and vodka, in California.

[115] *Janich Bros., Inc.* v. *American Distilling Co.,* 570 F.2d at 856. The Court did recognize that in some cases "a given size might be so significant that a chain retailer would select the overall line on the basis of that size. . . ." *Id.*

At least one recent Court of Appeals opinion has taken this approach. In *Pierce Packing Co.* v. *John Morrell & Co.*, the Ninth Circuit considered allegations that the defendant had attempted to monopolize the Montana "pork and pork products" market by selling "pork loins, private label bacon and private label [72] frankfurters" at prices below cost.[118] At trial, the district court judge had permitted the defendant to introduce evidence concerning "sales of unrelated products" to "show that [defendant's] total Montana sales were profitable and that the relevant products were not sold below marginal cost."[119] The Court of Appeals concluded that the evidence was properly admitted because it

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[116] IDF 56–58, 107–110, 181–182, 185–186, 234–238, 288. The only possible exceptions may have been Laub in Cleveland, which made 58% of its sales to restaurants and also sold many specialty breads, and Ward in Cleveland. IDF 289–290. Any wholesaler that can produce advertised label bread can produce private label bread just as easily. The wholesale bakers that exited therefore could have marketed both private label and advertised label bread just as Continental did. It would be more difficult for an exclusively private label baker to begin marketing advertised label bread as well, because of the time and promotional costs associated with developing an advertised label.

Laub's strong emphasis upon restaurant and specialty sales makes it unlikely—contrary to Commissioner Bailey's suggestion—that Continental's prices to retail grocers were "a major cause" of Laub's exit from the Cleveland market.

[117] RAP at 33, *citing* Biechner, Tr. 3553–54; Jones, Tr. 3700; Nissen, Tr. 10145–48; Inglis, Tr. 3786; Dierker, Tr. 9790–91.

[118] *Pierce Packing Co* v. *John Morrell & Co.*, 633 F.2d 1362, 1363 (9th Cir. 1980).

[119] *Id.* at 1364.

> made the fact of the profitability of [defendant's] Montana operations, both generally and with respect to pork and the particular pork products involved in this case, more probable than it would have been without the evidence.[120]

In short, the Court of Appeals sustained the consideration of the profitability of "pork and pork products," rather than simply price-cost comparisons for pork loin and private label bacon and frankfurters, in determining whether predatory pricing had in fact occurred. The same principles arguably should be applied here. Continental's overall revenues from and variable costs **[73]** associated with its sales of all white pan bread products—both advertised label and private label—should quite logically be considered in determining whether it sold products at prices below average variable cost.[121]

The record evidence in this case does not satisfy the test for predatory pricing that the Commission has adopted, whether or not advertised label and private label sales are considered together. As we indicated *supra*, sales at prices that equal or exceed average variable cost will be presumed to be legitimate, while sales at prices below average variable cost will be presumed to be predatory. The Administrative Law Judge determined that Continental sold certain white bread products at prices below average variable cost on a number of occasions. However, to make that determination, the ALJ assumed that Continental's variable costs were uniformly and persistently **[74]** equal to eighty percent of its "total allocated costs." IDF 45. There are two important difficulties with this assumption. First, it is unrealistic to assume that Continental's variable costs were always equal to eighty percent of its total allocated costs, throughout the period of time under consideration in this case, and in each of the five separate relevant geographic markets. Second, the ALJ derived the eighty percent figure by comparing Continental's variable costs in 1971 with its *revenues* in 1971, rather than with its total *costs*. IDF 45; *see* CX 262C–D. Since revenues frequently differ from total costs, there is no way of knowing whether the eighty percent figure accurately reflects the relationship between Continental's variable and total allocated costs. For these reasons, the Commission has determined not to rely upon the [75] "eighty percent" assumption that the ALJ developed. The following subsections apply more traditional evaluative techniques to Continental's pricing conduct in each of the five relevant geographic markets.[122]

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[120] *Id.*

[121] In the collateral Northern California private litigation, neither the District Court nor the Court of Appeals expressly addressed the question of whether advertised label and private label bread sales should be considered separately or together. *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 461 F.Supp. 410 (N.D. Cal. 1978), *rev'd on other grounds*, 668 F.2d 1014 (9th Cir. 1982), *cert. denied*, 103 S.Ct. 57 (1982).

The Commission has in the past taken the position that private label and branded label sales should not be aggregated to determine whether sales of private label milk at lower prices than advertised label milk to a retailer represented unlawful *secondary*line discrimination. *Beatrice Foods Co.*, 76 F.T.C. 719, 805–07 (1969), *aff'd sub nom. Kroger Co.* v. *FTC*, 438 F.2d 1372, 1379 (6th Cir. 1971), *cert. denied*, 404 U.S. 871 (1971). However, the Commission noted that the key issue is whether the favored retailer is given a competitive advantage over competing retailers as a consequence of being able to purchase the cheaper private label milk. *Beatrice Foods Co., supra*, 76 F.T.C. at 806. That position arguably should not apply when disfavored retailers may also purchase private label products at the same price. *Borden Co.* v. *FTC*, 381 F.2d 175, 180 (5th Cir. 1967).

a. Denver Market

Prior to 1964, the ALJ determined that in the Denver market,

> wholesale bakers did not compete on the basis of the wholesale or retail prices of their products. . . . There were meetings or communications between them prior to any price move, which all the wholesale bakers took at the same time.

IDF 63. Largely as a consequence of this arrangement, no wholesaler sold private label bread. IDF 65. However, in early 1964, after three years of effort, Associated Grocers—a cooperative of independent retail grocery stores together accounting for four percent of retail grocery sales in the Denver area—induced Interstate and Continental to negotiate the development of a private label program. IDF 67, 68. In August, 1964 Continental entered into a written agreement to supply [76] Tender Crust private label bread—including one pound expanded loaf, 1.25 pound round top, 1.25 pound sandwich bread, and hamburger and hot dog buns—to members of Five States, a cooperative company that Associated Grocers organized for its private label program. IDF 69–72. The agreement provided, *inter alia,* that in the event that Continental reduced its advertised label prices below their June, 1964 level, it would reduce the corresponding Tender Crust price to at least one cent below the advertised label price.[123] Continental expected a price of $.175 for its one pound Tender Crust loaf to generate revenues forty-six percent above variable cost, because its "cost to the doors of its plant"—including direct costs plus "other manufacturing," "operating," "office," and "packers"—would be nine and one-half cents per one pound loaf. Continental expected its other private label products to make similar revenue contributions. CX 1525 A, C–K. Continental retained the Tender Crust private label business until the middle of 1978, and then reacquired it in late 1979. IDF 94.

Complaint counsel argue that Continental sold Tender Crust at prices below average variable cost at various times between 1965 and

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[122] The ALJ's assumption as to the relationship between Continental's variable and total allocated costs does not in any event establish any significantly lengthy instances of sales at prices below average variable cost, as the discussion in each subsection indicates.

In conducting our analysis, we emphasize the evidence that complaint counsel presented, because complaint counsel bear the burden of proving sales at prices below average variable cost, and if the evidence they adduce is not adequate, then a finding of sales at such prices cannot be sustained. The cost evidence in the record might be considerably better if Continental had supplied certain subpoenaed accounting forms in a timely fashion, or if complaint counsel had been willing to accept Continental's later tender of the forms after the entry of a sanctions order against it. The sanctions order is discussed in Part IV, *infra.*

[123] IDF 73, 78. In 1967, this prescribed differential was increased to three cents. IDF 80.

1967. CPF 8–191, 8–192. As support for that position, they argue that (1) Continental's total costs for producing Tender Crust in the third quarter of 1967 amounted to $.1659 per one-pound loaf; (2) eighty percent of that figure is $.1327; (3) in 1965, Continental sold 10,000 loaves of Tender Crust to [77] one grocer for $.125 per loaf; (4) from June, 1965 to February, 1966, Continental sold Tender Crust to another grocer for $.125 per loaf; and (5) in the fall of 1967, Continental sold Tender Crust for $.1305 per loaf. CPF 8–191, 8–192; *see* CAB at 28. The ALJ relied upon the foregoing data and cost assumptions to conclude that Continental sold Tender Crust at prices below average variable cost in November, 1967 and March, 1968. IDF 82, 83, 85.

These data cannot support a finding that Continental sold Tender Crust at prices below average variable cost for a significant period of time. As we indicated *supra*, we cannot assume that Continental's variable costs were always eighty percent of its total costs, whether in 1967 or otherwise; a more detailed depiction of actual average variable costs must be used. That is particularly important where, as here, the respondent argues that its variable costs were considerably lower. Continental argues that its variable costs per one pound loaf amounted to only $.095 per loaf at the time it entered the [78] Tender Crust contract in July, 1964,[124] and the prices at issue exceeded that figure by an estimated three cents to eight cents per loaf during the cited time periods. CX 1728. Moreover, the sales cover one pound Tender Crust bread alone; there is no evidence that if all Tender Crust private label products were included—including other loaf sizes and hamburger and hot dog buns—revenues would not have exceeded costs by an even greater degree. Furthermore, these data all relate to private label sales alone. There is apparently no evidence in the record that—when private label and advertised label sales are aggregated—Continental made sales at prices below average [79] variable cost. In the absence of any other evidence that Continental sold white bread at prices below average variable cost in Denver, the Commission has determined to dismiss the Section 2(a) count as to that market.[125]

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[124] RAP at 20, 50, *citing* CX 1525; RPF 123. CX 1728, which sets forth the expenses associated with sales of one pound loaves of Wonder bread and Tender Crust from the first quarter of 1964 through the last quarter of 1967, indicates that the "cost to doors" associated with a one-pound loaf of Tender Crust increased from $.09 in the third quarter of 1967, when the private label contract with Associated Grocers began, to as much as $.10 in the third quarter of 1966, and then declined to $.098 in the fourth quarter of 1967. CX 1728C, 1728Y, 1728Z–5.

Complaint counsel argue that CX 1728 should be disregarded because it is "contradicted by the regular business records of CBC" and because some of the costs used were estimated as percentages of list price. CAB at 61–62. However, the "regular business records" cover overall plant operations, while CX 1728 covers only one pound Wonder bread and Tender Crust bread. Moreover, most of the costs employed were actual; only a few were estimated on the basis of percentages of list prices. CX 1722H, R–Y, Z–21 through Z–31.

[125] In the private suit against Continental in Denver the Court of Appeals sustained a finding of liability under Section 2(a) of the Clayton Act. *Continental Baking Co.* v. *Old Homestead Bread Co.*, 476 F.2d 97 (10th Cir.), *cert. denied*, 414 U.S. 975 (1973). However, the Court noted that the record contained evidence of "sales below cost" for only "a very short period" and therefore appears to have relied primarily upon Continental's construction of

(footnote cont'd)

b. *Twin Cities Market*

In this market, complaint counsel argue that Continental sold Wonder roundtop and sandwich breads from its Minneapolis bakery at prices below average variable cost for one and one-half months in the middle of 1967. CPF 9–98; *see* CAB at 28. As support for that position, they point out that during that period (1) Continental's fully allocated costs of manufacturing and distributing those products were $.2512 and $.2513 per loaf respectively; (2) eighty percent of $.2512 is $.201; and (3) Continental sold Wonder roundtop and sandwich breads for $.20 per loaf during the one and one-half month period. CPF 9–96, 9–98; *see* CAB at 28. Complaint counsel also argue that Continental sold Pantry Pride (a controlled label bread) at a price below average variable cost for two months in late 1967. CPF 9–111; *see* CAB at 28. As support for that position, they [80] point out that during that period: (1) $.156 per loaf represented eighty percent of Continental's fully allocated costs; and (2) Continental sold Pantry Pride for $.1519 per loaf. The ALJ relied upon these data to conclude that Continental sold Wonder round top and sandwich bread at prices below average variable cost for one and one-half months in 1967, and sold Pantry Pride to a Minneapolis retailer at prices below average variable cost for two months in 1967. IDF 128, 131. However, these calculations also rely upon the "eighty percent" assumption, and there apparently is no other record evidence that Continental sold any white bread products at prices below average variable cost in the Twin Cities market. The Commission has therefore determined to dismiss the Section 2(a) count as to that market.

c. *Southern California Market*

In this market, Continental's bakeries included plants in Beverly Hills, San Pedro, and San Diego. IDF 175–177. Complaint counsel argue that Continental sold a number of private label white pan bread products from the Beverly Hills bakery at prices below average variable cost in the Southern California market for a four-week period ending in August, 1973. As support for this position, complaint counsel cite Continental's own "reckoning" in an internal study that its "total gross sales" were less than its [81] "total variable costs."[126] However, it is important to note that the study covered a large num-

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a large new plant in 1962 to sustain the requisite finding of predatory intent. *Id.* at 104–05. As we have noted *supra*, there are a variety of perfectly legitimate reasons for constructing new, more efficient plants and then selling at prices sufficiently low to maximize production efficiency and minimize unit costs. We therefore decline to adopt the conclusion of the Court of Appeals.

[126] CPF 11–46, *citing* CX 441F ("McCoy 1 lb. white"), Z–170 ("B&S Reg"), Z–171 ("B&S Buttermilk"), Z–188 ("Jordano 8 pk. Bun"), Z–198 ("Stop'n Go 8 pk. Dog"), Z–199 ("Mayfresh 8 pk. Dog"). Continental's calculations were apparently made as part of "a special, one-time 'profit by variety' study" of the Beverly Hills bakery in August, 1973. RPF 325.

ber of varieties of bread products, and the fact that revenues from six of them may not have covered all variable costs during one four-week period cannot therefore support a finding that Continental sold its complete white bread private label line, or its complete white bread advertised label line, at prices below average variable cost during that period. Continental argues that its study indicates that it sold every brand and size of white pan bread from the Beverly Hills bakery, of which there were several dozen, at prices higher than "incremental costs," with the exception of one that represented less than one percent of the sales of the bakery. RPF 325, *citing* CX 441E. Continental argues in addition that "when the profits of Wonder white bread are included, the total white bread sales of the Beverly Hills bakery were profitable on a full cost basis." *Id., citing* CX 441. Continental argues further that its standard cost reports for the bakery for June, 1973 through January, 1974 show a sixty percent gross profit margin for advertised label bread, and a forty percent gross profit margin for private label bread, during that period.[127] The ALJ apparently concluded that the record evidence was not [82] sufficiently strong to establish that Continental made any sales in this market at prices below average variable cost. *See* IDF 219, 222.

On balance, the record evidence does not support concluding that Continental engaged in predatory pricing in the Southern California market. Complaint counsel cite only four weeks of sales at prices below average variable cost, and the Commission predatory pricing standard requires a showing of sales at prices below average variable cost for a significant period of time to create a presumption of predatory pricing. A single isolated month of sales at such prices cannot satisfy that standard. Moreover, as in the other markets, the evidence that complaint counsel have developed focuses upon different "types" of private label white pan bread—in this case, sales of only one or a few private label bread varieties—rather than focusing upon all private label bread products collectively. Furthermore, the record evidence does not establish that Continental made any white pan bread sales in the Southern California market at prices below average variable cost, when both advertised label and private label bread sales are aggregated. The Commission has therefore determined to dismiss the Section 2(a) count as to this market. [83]

d. *Northern California/Western Nevada Market*

Continental served this market from three bakeries located in San Francisco, Sacramento and Oakland; the first two produced variety and white pan breads and cake products, while the Oakland bakery produced just variety and white pan breads. IDF 231. Complaint counsel argue that Continental sold certain products at prices below average variable cost in this market.[128] More particularly, complaint counsel argue that Continental sold private label "cello" (one pound "expanded" loaf) at prices below average variable cost (1) for four weeks, ending on July 22, 1972 from its Oakland and San Francisco bakeries; (2) for four weeks, ending on August 19, 1972 from its Sacramento bakery; (3) for five weeks, ending March 30, 1974 from its Oakland bakery; (4) for four weeks, ending February 23, 1974 from its San Francisco bakery; (5) for five weeks, ending June 9, 1974 from its Oakland bakery; (6) for four weeks, ending April 27, 1974 from its San Francisco bakery; and (7) for five weeks, [84] ending September 28, 1974 from its Oakland bakery.[129] Continental admits in response that it sustained "bookkeeping losses on a full cost basis in 1971–74 because of federal price controls, the labor strike and substantial cost escalations . . ." RPF 394. However, Continental argues that its plants always had a "positive cash flow" during that period; that in every quarter from 1972 through 1975 its private label price "substantially exceeded the marginal cost of producing and selling those items. . . . (by about 35%);" and private label products contributed profits of $2.8 million during those years.[130] [85]

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[127] RPF 326, *citing* CX 433-Z31, CX 435C, CX 436D, CX 437C, CX 438C, CX 439G.

The ALJ apparently did not evaluate or rely upon the foregoing evidence. Instead, he simply assumed that "Continental's [total] costs were comparable to American's" in 1973; assumed that Continental's average variable costs were eighty percent of American's total costs; and therefore concluded that Continental's $.172 price for its private label bread during the July, 1972 - August, 1973 period was lower than its average variable cost during that period. IDF 249, 254.

The study that complaint counsel rely upon to establish sales at prices below average variable cost—CX 3010—is helpful, but it suffers from two major deficiencies. First, the data for 16 ounce white round top bread, 24 ounce white round top bread, and hamburger and hot dog buns should be aggregated, in order to determine whether revenues from sales of those products collectively fell below variable costs in any of the relevant time periods. As we noted *supra*, the instrument of predation should at least include the aggregated sales of all private label white pan bread products. It is not clear from the record whether these three products alone accounted for all of Continental's private label line; if it also sold other private label products from its Bay Area plants, then the costs and revenues associated with those sales should be aggregated as well. In any event, when sales of the three identified products are aggregated, one finds that collective revenues from sales of these products exceeded variable costs as defined by complaint counsel in all three of the 1972 time periods during which [86] predatory pricing allegedly occurred.[131] Of the remaining five periods that complaint counsel cite, the data for the two periods in the second quarter of 1974 are less useful because they do not account for the revenues and costs associated with sales of hot dog and hamburger buns during those periods. Since hot dog and hamburger buns account for a substantial portion of the private label revenues from each of the three Bay Area plants, it is possible that total private label revenues might actually have exceeded variable costs as defined during one or both of those periods had the revenues and costs associated with hamburger and hot dog bun sales been included.

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[128] CAB at 28, *citing* CPF 12–144, 12–146, 12–149, 12–150; CAB at 71–72, *citing* CX 3010, IDF 252, 254, 255.

[129] CPF 12–144, 12–146, *citing* CX 3010A; *see* CAB at 71; RX 3010; Diener, Tr. 12227, 12230–78. Complaint counsel also argue that Continental sold a number of individual bread varieties at prices below average variable cost during the five week period ending on September 9, 1973 CPF 12–147, 12–148, 12–150, *citing* CX 733. However, as we have noted *supra*, disaggregation beyond the level of private label white pan bread and advertised label white pan bread is not appropriate. Moreover, the variable costs associated with *all* of the individual bread varieties in CX 733 cited by complaint counsel exceeded revenues from sales of those varieties by only $1,207 during the cited period. By way of contrast, the collective revenues from sales of the third variety listed in CX 733—and CX 733 covers a large number of varieties—exceeded the total variable costs associated with sales of that variety by $9,027. *See* CX 733C. Complaint counsel criticize Continental's treatment of certain costs as fixed and others as variable for certain other varieties in CX 733. CPF 12–149. However, they do not provide any indication of whether any sales at prices below average variable cost would be shown if all private label white pan bread were aggregated, and all advertised label white pan bread were aggregated.

[130] RPF 394–396, *citing* RX 125, RX 3010–A. Continental argues that its "marginal cost" for northern California sales amounted to about eleven cents per loaf at the time it lowered its price to $.172 in 1972.

That leaves three time periods—a five-week period ending in March, 1974 concerning the Oakland bakery; a four-week period ending in February, 1974 concerning the San Francisco bakery; and a five-week period ending in September, 1974 concerning the Oakland bakery—during which aggregate private label revenues may have fallen below variable costs as complaint counsel have defined them. There are, however, four significant impediments to basing a finding of liability upon these data. First, they assume that a variety of costs should be treated as completely variable, when at least portions of them probably should be treated as fixed, particularly over the very short periods of [87] time at issue.[132] In particular, at least portions of the costs associated with such items as "local plant vehicular expense," "tractor trailer equipment," "vacation pay," "health and welfare pension fund," "sales supervisors' salaries," "garage labor," and "executive" should very probably be treated as fixed costs, particularly in connection with the four or five week periods the data cover. It is unclear whether revenues would still fall below variable costs in any of these three periods if these adjustments were made. The second problem is that the cited time periods are too short and episodic to satisfy the Commission standard for predatory pricing. Third, as we have indicated *supra*, it would be perfectly logical to aggregate branded and private label sales in this industry to evaluate alleged predatory pricing, and the record evidence does not establish any such sales when Continental's Northern California/Western Nevada sales are aggregated in that fashion. [88]

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[131] Sales of these products from the Oakland, San Francisco, and Sacramento bakeries respectively generated revenues of $1,012, $118, and $813 over variable costs as complaint counsel have defined them during these periods.

[132] The study assumed that the following items are variable costs: vehicle, accident, sundries, fuel, transport labor, local plant vehicular expense, outside express and freight, operating labor, packers, electric power, repairs and renewals, telephone, telegraph, janitor supplies, rent, lease cars, tractor trailer equipment, vacation pay, illness payments, health and welfare pension fund, transport carriers, cartons and selling tapes, sales managers, salesmens' salaries and commissions, sales supervisors' salaries, other route labor, sales contests and prizes, special liability and retroadjustments, payroll taxes, garage labor, executive, supplies, repairs, tires. By contrast, Continental argues that when a bakery has unused capacity, only six items should be treated as variable: the cost of ingredients, the cost of the wrapper, salesmen's commissions, direct production labor, oven fuel, and pan grease. The first three items account for more than ninety percent of variable cost. RAP at 19–20, *citing* Dierker, Tr. 9717–18, 9727, 9760.

Fourth and finally, Continental may assert as a complete defense in response to the foregoing data that those sales simply represented a good faith effort to meet the competition of competing firms. The Supreme Court recently determined that "territorial price differences that are in fact responses to competitive conditions" satisfy the requirements of the meeting competition defense.[133] In short, if a seller has a good reason to believe that competing firms are charging lower prices in a particular market, it may respond with comparably low prices on a *territorial* basis, rather than on a customer-by-customer basis.[134] The Court determined that this standard would be satisfied

> by showing that a reasonable and prudent businessman would believe that the lower price he charged was generally available from his competitors throughout the territory and throughout the period in which he made the lower price available.[135]

The Court also determined that the defense could be asserted even if the prices at issue were offered to secure new customers, rather than to retain old customers.[136]

The record evidence establishes that the prices noted above were offered as part of a good faith effort to meet the competition of competing sellers. In early 1972, Inglis began [89] selling one pound private label bread for seventeen cents per loaf; Campbell-Taggart took the Wentz private label account from Continental by offering one pound bread for seventeen cents per loaf; and American lowered its private label price to $.172 per loaf after discovering that Campbell-Taggart had adopted $.172 as its market-wide price, and had offered that price to Food Fair, one of American's private label customers.[137] American then offered that price to Mayfair Stores, a large Continental private label account, to cover its private label purchases throughout the

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[133] *Falls City Industries, Inc.* v. *Vanco Beverage, Inc.* 103 S.Ct. 1282, 1295 (1983).

[134] *Id.* at 1295–97.

[135] *Id.* at 1297.

[136] *Id.* at 1294–95.

[137] RAP at 57, *citing* RX 30–32, RX 34–44; McGinley, Tr. 3975–80, 3985–86; CX 647; Temkin, Tr. 4297–98, 4305; Frielink, Tr. 3380–82.

Northern California/Western Nevada market. RAP at 58, *citing* RX 93; Temkin, Tr. 4298-99. After learning of this offer, and that the same price had been offered to 7-Eleven Stores, the largest private label buyer in the area, and to Cala Markets, Continental lowered its private label price throughout the market to $.172.[138] That price persisted until August, 1973; the market price then increased to $.22 in September, 1973. RAP at 59, *citing* CX 780. In its opinion in the collateral private litigation between Inglis and Continental in Northern California, the Ninth Circuit Court of Appeals accepted this account and concluded: [90]

> This reveals much about the way the market for private label bread operated during the complaint period. Although the record does not always identify which of Continental's competitors initiated a price reduction, it does reveal how a price reduction to one customer quickly became the prevailing market price. Each bakery ignored this new price at its peril. Because the number of private label accounts was not large, buyers for those accounts communicated with each other and with all of the wholesale bakeries. Price reductions to one account did not long remain secret. We conclude, therefore, that there was a reasonable basis for Continental's assumption that a new price offered to one of its accounts by a competitor, which Continental did verify, would become available, with or without its assistance, to all of its existing and prospective customers. The weight of the evidence supports Continental's claim that its price reductions were good faith responses to competition. There was no need for Continental to verify that each customer had actually received a competitor's offer of an equally low price, as it did in the case of advertised bread.[139]

The record evidence before us supports this conclusion. Complaint counsel argue that American's offers did not justify Continental's marketwide price reduction because the offer to Mayfair covered only the Bay Area; Cala Markets operated stores only in San Francisco; and the Regional Vice-President who lowered Continental's price "was not certain of any offer to 7-11 [91] Stores" before he lowered the price.[140] The ALJ appears to have relied primarily upon the first point to reject the meeting competition defense in his decision. *See* IDF 250. However, in *Falls City* the Supreme Court made it clear that the defense should be sustained when it is "reasonable and prudent" to believe that the lower price offered is generally available from competing firms in the relevant market during the relevant time period; universal availability and complete certainty are not required. Price competition was so intense in the Northern California market during the relevant period that Continental could reasonably have believed that the $.172 price its competitors were offering was generally available throughout the market, and that it would lose its private label accounts if it did not match those competing offers immediately.[141] The Commission has therefore determined to dismiss the primary line count in the Northern California/Western Nevada market.

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[138] IDF 249; RAP at 58; Frielink, Tr. 3223-24, 3294-97, 3379-83. The ALJ suggests that no other wholesalers sold private label bread at this price throughout the market. IDF 250. However, Continental argues that Campbell-Taggart and American also quoted a single private label price to all their customers. RAP at 59 n.1, *citing* McGinley, Tr. 3975-80, Frielink, Tr. 3381-82.

[139] *William Inglis & Sons Baking Co.* v. *ITT Continental Baking Co.*, 668 F.2d at 1047. The Court nevertheless reversed the district court's judgment notwithstanding the verdict on the issue, because although it believed its conclusion to be the *most* reasonable conclusion, it could not say that it was the *only* reasonable conclusion possible. *Id.* at 1047-48. It remanded that issue, *inter alia*, to the district court for a new trial.

[140] CAB at 69-70, *citing* McGinley, Tr. 3980, Frielink, Tr. 3229, 3383.

e. *Cleveland Market*

The allegations of anticompetitive conduct in the Cleveland market arise primarily from a contract Continental negotiated in 1972 to supply private label bread products to Pick N Pay, a local grocery chain that had theretofore operated its own captive bakery. IDF 305. The ALJ found that during this period: [92]

> There was excess bread capacity that could service the Cleveland market, especially Continental's Akron bakery which was operating at about 50% of capacity, *i.e.*, one and 1/4 shifts. . . .

IDF 300. As a consequence, the Akron bakery was generating pre-tax losses of over $3,000 per week, and Continental was seriously considering closing it. IDF 305. Continental believed that if it began to supply private label bread to PNP, it could convert its Akron bakery's losses into a "substantial profit," and realize a profit net of "fully allocated costs" of $240,000 or more per year.[142] Moreover, Continental expected to increase its sale of branded label products to PNP; in fact, its sale of Wonder bread products to PNP increased by $20,000 per week after it began to supply private label products. IDF 317. The contract became effective in July, 1973. CAB at 74. However, the cost of providing private label bread to PNP turned out to be much higher than Continental had expected. IDF 319. As a consequence, Continental renegotiated its contract with PNP to secure higher prices in September, 1974. IDF 328–332.

Complaint counsel argue that Continental sold private label bread to PNP at prices below average variable cost "on both a single product and total [private label] business basis." CAB at 31. As support for that position, they argue that (1) in the [93] four week August, 1973 accounting period Continental's revenues from its total private label sales to PNP fell below the variable costs associated with those sales,[143] and its revenues from its overall sales of *all* products to PNP fell below the variable costs associated with those sales;[144] (2) in the five-week December, 1973 accounting period, Continental's revenues from its total private label sales to PNP fell below the variable costs associated with those sales;[145] and (3) in the four week May, 1974 accounting period, Continental's revenues from its total private label sales to PNP fell $16,600 below its variable costs.[146] In short, complaint counsel argue that [94] when Continental's total private label white pan bread product sales to PNP are considered, its revenues from those sales did not cover its variable costs in July, 1973, December, 1973 and May, 1974.[147]

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[141] McGinley, Tr. 3976; Johnson, Tr. 3892. I am indebted to Commissioner Bailey for her assistance in resolving the meeting competition issue.

[142] IDF 305, 315. This figure was derived by converting the weekly estimate of at least $6,000 in profits in IDF 315 into an annual profits estimate, and then subtracting $70,000 in annual "proof of performance" payments. Continental paid $210,000 to PNP from 1973 through the first three months of 1976, or approximately $70,000 per year, to "reimburse Pick N Pay for promotions of private label products commensurate with the estimated book value of the Pick N Pay bakery." IDF 313.

Continental argues in response that "The profitability of the PNP private label account was never significantly below break-even on a variable cost basis." RPF 479. Continental argues, for example, that (1) in August, 1973 private label sales showed a "weekly profit" of $690; (2) in December, 1973, private label sales showed a "variable profit" of $286 per week; (3) in December, 1973 and January, 1974 the whole line of private label bread and buns produced an incremental profit of $658 per week; (4) in May, 1974 the Pick N Pay "account as a whole broke even on an incremental basis . . .;"[148] and (5) under the contract renegotiated with PNP in 1974, private label sales alone generated profits in the first three months of [95] 1976, in July, 1976, and in August, 1977.[149] In short, Continental argues that its revenues from the PNP account usually covered the variable costs associated with that account. Continental admits that some of its documents from the contract renegotiation period show that it incurred full cost and some variable cost losses when its private label sales to PNP are considered in isolation. RPF 480. However, Continental argues that the relevant measure should be whether Continental earned greater *total* profits (or incurred fewer losses) on both advertised label and private label sales as a consequence of the PNP private label contract.

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[143] CAB at 86, *citing* CX 800B, CX 883C. CX 883C actually shows that revenues exceeded variable costs by $690. However, complaint counsel argue that $5,384—4/52 of the $70,000 annual promotional payment—should be treated as a variable cost and subtracted from that figure. CAB at 86.

[144] CAB at 85-86, *citing* CX 800B; CPF 13-205, 13-207.

[145] CAB at 86, *citing* CX 2639T. CX 2639T actually shows that revenues exceeded varible costs by $286, but complaint counsel argue that $6,730—5/52 of the $70,000 annual promotional payment—should be treated as a variable cost and subtracted from that figure. CAB at 86.

[146] CPF 13-262, 13-263, 13-266, 13-267, *citing* CX 2608B, CX 2610, CX 2636C, CX 2665A.

[147] Complaint counsel also argue that Continental sold certain individual varieties of bread to PNP at prices below average variable cost or "total direct cost" or "cost to doors" at various times throughout the relevant period. CPF 13-265, *citing* CX 2639Z-4 (two varieties; however, a third variety, one pound white bread was priced significantly *above* average variable cost); CPF 13-266, 13-267, *citing* CX 911Z-34 (one variety), CX 915F,H,I (three varieties), CX 2677A,E,O (three varieties); CAB at 86; *citing* CX 2632 (two varieties), CX 2639Z-4 (two varieties); CAB at 87, *citing* CX 2678 (five varieties; however, total revenues on all varieties exceeded total cost to doors by $8,838). We have already noted, however, that revenues and costs should at a minimum be aggregated across the entire private label or advertised label line.

[148] RPF 479, *citing* CX 833C, CX 2639R, CX 2639A-Q, and CX 2636-C.

[149] RPF 481, *citing* CX 829, CX 2616-A, CX 2615, CX 2658, CX 2668, CX 2661, CX 2660, RX 309, Schmidt, Tr. 11189, 11191, 11192.

RPF 480. That measure would account for profits and losses attributable to advertised label sales, as well as to private label sales.

The ALJ considered these arguments and reached the following conclusions: (1) the Akron bakery sustained a $16,000 loss on its PNP private label contract in the four-week period ending on August 25, 1973;[150] (2) in December, 1973, Continental's private label prices to PNP covered incremental costs for "8 Pack" hamburger and hot dog buns and one pound white bread loaves, but did not cover incremental costs for 20 oz. and 24 oz. white bread loaves;[151] (3) in May, 1974 Continental "basically broke even on the total [PNP] business" on an incremental basis, losing $16,000 **[96]** on PNP private label and making $15,100 on sales of branded products to PNP;[152] (4) in January, 1976 Continental sold its 24 oz. "Giant Sandwich" loaf and "8 Pack" hamburger buns at prices below incremental costs;[153] (5) during the first three months of 1976, Continental sold "three other bun varieties" under the contract at prices below "incremental costs;"[154] and (6) in July, 1976 Continental's private label sales under the contract produced losses on both a "full load" and a "variable" basis.[155] In short, the ALJ found that Continental's revenues from its overall private label sales to PNP fell below the variable costs attributable to those sales only in August, 1973, May, 1974, and July, 1976.

The foregoing summaries prepared by the parties and by the ALJ do not provide the kind of detailed itemization of the costs that should respectively be treated as fixed and variable during the relevant time period that is needed to determine whether Continental actually sold white pan bread products at prices below average variable cost for a significant period of time in the Cleveland market. In any event, complaint counsel identify only three non-consecutive months in which Continental's revenues **[97]** from total private label sales to PNP may not have covered the variable costs associated with those sales. The ALJ does not endorse complaint counsel's conclusion as to December, 1973 and identifies only one additional month over two years later in which such an imbalance may have occurred. These discontinuous and short-lived instances cannot satisfy the Commission standard for predatory pricing.

In her concurring and dissenting opinion, Commissioner Bailey discusses her own analysis of prices and costs in the Cleveland market. Commissioner Bailey's more detailed price-cost comparisons do not, however, affect the conclusion that Continental's pricing behavior did not violate the Commission standard. In conducting her analysis, Commissioner Bailey treated almost all selling and distribution costs as variable.[156] In addition, she treated Continental's reimbursement of PNP's private label promotional expenses as a variable cost.[157] Finally, she relied upon the same documents—but not the eighty percent assumption—that the ALJ relied upon in making his cost calculations.[158] Commissioner Bailey found that Continental sold white pan bread to PNP under the private label contract at prices below average variable cost during the **[98]** months of June, 1974 (87.0% of average variable cost) and July, 1976 (99.3% of average variable cost).[159]

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[150] IDF 320, *citing* CX 800-B, CX 882, CX 2628.

[151] IDF 322, *citing* CX 2632-A-F, CX 2639-H-K.

[152] IDF 324, *quoting* Breines, CX 2608-B. This figure does not account for the $70,000 annual payment for "proof of performance." IDF 324, *citing* CX 2693-A-B. However, it apparently does account for private label variety, premium, and sweet good sales, as well as white bread sales.

[153] IDF 334, *citing* CX 2669-A.

[154] IDF 335, *citing* CX 2668-B.

[155] IDF 336, *citing* CX 2661-C.

Commissioner Bailey's calculations provide a helpful comparison of prices and costs under the PNP private label contract. However—like the calculations of complaint counsel and the ALJ—they do not create a presumption that Continental violated the Commission standard. They reveal only two months—over two years apart—when Continental's revenues from its private label white pan bread sales to PNP under the contract failed to cover variable costs, and the percentage point shortfall in the second month was very small. Two widely-separated months of sales at prices below average variable cost are simply not sufficient to satisfy the "significant period of time" requirement of the Commission predation standard.

The allocation of expenses between fixed and variable costs in Commissioner Bailey's analysis creates additional difficulties. In particular, at least a portion of Continental's reimbursement to PNP of promotional expenses associated with its **[99]** private label bread sales should be treated as a fixed rather than a variable cost. Continental believed that "any baker who secured [PNP's private label] business would either have to purchase [PNP's captive] bakery assets or compensate Pick N Pay for their book value."[160] Instead of simply paying for the assets, however, the parties agreed that Continental would pay $210,000, an equivalent amount, to PNP over the July, 1973–April,

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[156] Concurring and dissenting opinion of Commissioner Bailey at 12, *citing* Gase, Tr. 9421–22, RX 309, CX 2661.

[157] *Id.* at 12–13 and n. 16.

[158] *Id.* at 14, *citing* IDF 320–325, 347.

[159] *Id.* at 14. Commissioner Bailey also found that Continental collectively sold *all* of its private label products to PNP (including variety, premium and sweet goods, as well as white pan bread) at prices below average variable cost during four months (two of which were consecutive) in 1973 and 1974. However, given their differences, variety, premium and sweet goods probably should not be included in the same relevant product market as white pan bread products. Moreover, such products and white pan bread do not in any event appear to be goods of "like grade and quality," since they are not physically identical.

Contrary to Commissioner Bailey's assertion (*id.* at 20), the record evidence does not indicate that Continental sold private label bread products to PNP at prices below fully allocated cost for four years. As she herself points out, the documents she relies upon "do not detail every month of the four year period, but summarize performance at irregular intervals . . ." *Id.* at 11 n. 15.

[160] RAP at 64–65, *citing* CX 2683, Vail, Tr. 9968, 9971–72. A number of other retailers had insisted upon and received similar commitments when they switched from captive baking to purchasing private label bread from wholesalers. *Id.* at 65 n.1.

1976 period when PNP presented proof of promotional efforts such as advertising.[161] Nevertheless, even if the payments are treated as entirely promotional, at least a proportion should be treated as fixed costs, because of the investment component of promotional efforts that we have described *supra*. Treating some of the reimbursement to PNP in that fashion would of course reduce Continental's average variable costs to some degree, although the record evidence does not establish the percentage of the payment that should be excluded from variable costs. It seems likely, however, that the difference would at least be substantial enough to place Continental's revenues from private label sales to PNP in July, 1976 above variable costs, leaving only the month of June, 1974 as an instance of sales at prices below average variable cost. [100]

Apart from these considerations, it is important to recognize that the evidence discussed above relates only to private label sales of white pan bread to PNP. It does not indicate whether the findings of sales at prices below average variable cost would persist if Continental's sales of branded white pan bread products were also considered. If the latter sales were considered, then the $16,000 loss on private label sales to PNP in May, 1974 would be countered almost completely by Continental's $15,100 in revenue above incremental costs from sales of branded products to PNP, yielding a net loss below incremental costs of only $900. IDF 324. Adopting the same approach with respect to the second instance in July, 1976 might produce the same result, although the ALJ did not include a finding as to Continental's revenues from branded products sold to PNP during that month. In addition, it should be noted that the price cost comparisons focus only upon Continental's sales to PNP; they do not represent an aggregation of costs and revenues associated with private label sales from the Akron plant to *all* private label buyers.[162] Including private label sales to firms other than PNP might very well indicate that revenues from all private label sales from the Akron plant exceeded the variable [101] costs associated with those sales throughout the relevant period. For all of these reasons, the Commission has therefore determined to dismiss the Section 2(a) primary line count in the Cleveland market.

2. Secondary Line Injury

The Commission must similarly establish a "reasonable possibility that a price difference may harm competition" in order to establish secondary line liability; that is, that the price discriminations alleged may have injured competition among competing buyers.[163] The Supreme Court has indicated that substantial price differentials between competing purchasers over time are sufficient to give rise to an inference of injury to competition.[164] However, the only remaining price differential at issue in the secondary line aspect of this case concerns a price disparity between advertised label bread (Wonder bread) and private label bread in the Northern California/Western Nevada market. The Supreme Court has recognized that in these circumstances the difference in wholesale prices may be accounted for by the existence of a consumer preference for the advertised label product, and that preference "should receive due legal recognition" in determining [102] whether an injury to competition has occurred.[165] As a consequence, it is not enough to establish in this case that Continental sold private label bread to a favored retailer at a lower price than the price at which it sold Wonder Bread to competing retailers. Such a difference may simply reflect a consumer preference for Wonder Bread at the retail level, and hence be perfectly legitimate, because the private label bread has a limited consumer franchise while the advertised brand is largely pre-sold through national advertising.[166] The record evidence indicates that the price Continental charged four grocery retailers for private label white bread products ranged from 25 percent to 38 percent lower than the price it charged two other retailers for Wonder bread between January, 1972 and December, 1974. These differentials are substantial, but there is no reason to believe that consumer preferences and the substantially greater costs associated with promoting Wonder bread do not largely or completely account for them.

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[161] *Id.* at 65, *citing* Kravitz, Tr. 5435–37, Vail, Tr. 9971, 9977.

[162] By contrast, the price-cost comparisons developed for the Northern California/Western Nevada market focus upon all private label bread sales from the Oakland, San Francisco, or Sacramento plants.

Moreover, as we indicated *supra*, the prices that Continental charged for private label white pan bread products in Northern California were in any event simply a good faith effort to meet [103] the competition of rival bread manufacturers. The Commission has therefore determined to dismiss the secondary line count in the Northern California/Western Nevada market.

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[163] *Falls City* v. *Vanco*, 103 S.Ct. at 1288.

[164] *Id.* at 1289; *accord, Beatrice Foods Co.*, 76 F.T.C. 719, 801 (1969), *aff'd sub nom. The Kroger Co.* v. *FTC*, 438 F.2d 1372 (6th Cir.), *cert. denied*, 404 U.S. 871 (1971), *citing United Biscuit Co. of America* v. *FTC*, 350 F.2d 615 (7th Cir. 1965), *cert. denied*, 383 U.S. 926 (1966) and *Foremost Dairies, Inc.* v. *FTC*, 348 F.2d 674 (5th Cir.), *cert. denied*, 382 U.S. 959 (1965).

[165] *FTC* v. *The Borden Co.*, 383 U.S. 637, 646 (1966); *accord, Borden Co.* v. *FTC*, 381 F.2d 175, 180–81 (5th Cir. 1967).

[166] *Borden Co.* v. *FTC*, 381 F.2d 175, 180–81 (5th Cir. 1967); *Beatrice Foods Co.*, 76 F.T.C. at 808–09; FTC Policy With Respect to Anticompetitive Practices In the Marketing of Gasoline, 3 Trade Reg. Rep. (CCH) ¶10,373 (1967). The ALJ concluded, without citing any evidentiary support, that some of the differentials were larger than any differential that could be attributed to consumer preferences. ID at 88. In the absence of any evidence to support that conclusion, we cannot accept it.

IV. SANCTIONS IMPOSED BY THE ADMINISTRATIVE LAW JUDGE

One final issue must now be addressed, relating to the imposition of discovery sanctions against Continental by the first ALJ to preside over this case. Resolving this issue is very important to preserving the integrity of the adjudicative process, and the Commission wishes to strongly reaffirm the power of Administrative Law Judges to impose such sanctions, as appropriate, in adjudicative proceedings. The relevant facts are as follows. In February, 1976, at the request of complaint counsel, ALJ Harry R. Hinkes issued a subpoena to Continental for certain documentary material.[167] Shortly thereafter, Continental filed a motion to quash or limit the subpoena.[168] In late March the ALJ denied that motion, but after an April prehearing conference he deferred Continental's obligation to comply with **[104]** the subpoena until July.[169] After several subsequent months of negotiation, complaint counsel reduced the scope of certain subpoena specifications on which compliance had been delayed. At a prehearing conference in October the ALJ ordered Continental to comply with the modified subpoena, and to submit a progress report on its compliance by December 10, 1976. Tr. 180–81. On that date counsel for Continental advised the ALJ that it would not comply with the portions of the modified subpoena requiring the production of four types of accounting forms, Forms 430 (cake portion only), 521, 526 and 528.[170] Form 430 reveals the volume of production and sale of each variety of bread and cake in units, weight and dollars. Forms 521, 526 and 528 provide, in differing degrees of aggregation, the expenses associated with baking groups of products, such as all bread, all cake, or all bread and cake combined. In conjunction with "recipes" that Continental did provide—showing how much of each ingredient and how much labor and baking time are used for each variety—complaint counsel believed that these forms would permit the **[105]** allocation of "all bread," "all cake," or "all bread and cake" costs to different bread varieties on the basis of units, weight, and value.[171]

Continental argued that the subpoenaed forms were not relevant to this case because, it alleged, the Commission had not endorsed and probably would not endorse complaint counsel's "current efforts to develop cost figures for individual bread varieties . . .".[172] Continental argued that, during the relevant period, it had only kept "cost and profit and loss records on the basis of the full bread product line (as distinguished from the cake line and the sweet goods line). . . .;" that complaint counsel had previously requested and received those records; and that those records

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[167] Mr. Hinkes served as the ALJ for this case until July, 1977. At that point, he asked to be relieved of his responsibilities for the case because he would shortly be presiding over the trial in *Kellogg Co.* Notice To Daniel H. Hanscom, Chief Administrative Law Judge (July 26, 1977). This case was then assigned to Miles J. Brown. Order Substituting Administrative Law Judge (August 2, 1977).

[168] Motion To Limit Or Quash Subpoena Duces Tecum (March 4, 1976).

[169] Order Denying Respondent's Motion To Quash Complaint Counsel's Subpoena of February 20, 1976, And Setting Prehearing Conference (March 18, 1976); Order Rescheduling Return On Complaint Counsel's Subpoena Duces Tecum Directed to ITT-Continental (April 19, 1976).

[170] Memorandum In Support of Complaint Counsel's Application For Sanctions Under Rule 3.38 (December 29, 1976), at 6–12.

[171] *Id.* at 9. Complaint counsel defined a "variety" of bread—such as "one pound white pan private label" or "18 ounce hearth rye loaf"—to be "a product which is identified separately on ITT-Continental's detailed accounting records." Complaint Counsel's Answer to Respondent's Motion For Oral Argument And Leave To File Additional Memorandum (April 20, 1977), at 2 n.**.

> show that in the various bakeries Continental's overall bread sales were profitable most of the time and that when they showed a loss it was only on a fully allocated basis which nevertheless contributed to overall plant profit.[173] **[106]**

Continental also argued that because it "did not keep cost figures by variety" during the relevant period, the fact that a given variety of bread might have been sold at prices below cost could not establish that those sales were made with the requisite predatory intent.[174]

In late December, 1976 complaint counsel applied to the ALJ for the imposition of a number of discovery sanctions—including adverse inferences and evidentiary restrictions—against Continental.[175] On March 22, 1977 ALJ Hinkes entered the following order:

> *It is ordered,* That complaint counsel are deemed to have established that ITT Continental has sold bread below cost no matter how cost is measured in the following geographic markets during the following time periods:

Akron, Ohio	1970 through 1974;
Beverly Hills, California	1967 through 1974;
Denver, Colorado	1964 through 1968;
Minneapolis, Minnesota	1964 through 1970;
Oakland, California	1967 through 1974;
Rochester, Minnesota	1964 through 1970;
Sacramento, California	1967 through 1974;
San Francisco, Calif.	1967 through 1974;
San Pedro, California	1967 through 1974;
Seattle, Washington	1968 through 1973; and
Youngstown, Ohio	1970 through 1974.

> *It is further ordered,* That ITT Continental may not introduce into evidence or otherwise rely upon the documents which ITT Continental has failed to produce. **[107]**
>
> *It is further ordered,* That ITT Continental may not object on the grounds that the withheld documents are better evidence, to complaint counsel's introduction and use of other relevant material and reliable evidence that ITT Continental made sales below

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[172] Letter from John H. Schafer, Counsel for Respondent, to the Honorable Harry R. Hinkes (December 10, 1976), at 2–3.

[173] *Id.* at 3. Continental argued that when the Commission issued the complaint in this case, it only had the overall "bread line" cost and profit evidence before it. Request For Pre-Hearing Conference and Alternative Request For Leave To File Further Memorandum (February 4, 1977), at 3.

[174] Letter from John H. Schafer, *supra* note 172, at 4.

[175] Complaint Counsel's Application For Sanctions Under Rule 3.38 (Dec. 29, 1976).

cost in the geographic markets and for the time periods specified.[176]

On March 23, the ALJ permitted Continental to apply to the Commission "for a review" of his order on the narrow policy question of whether it would be more appropriate for the Commission to seek District Court enforcement of the subpoena at issue than for the ALJ to issue the sanctions order.[177] Continental filed its appeal shortly thereafter. In explaining its earlier refusal to supply the subpoenaed documents, Continental once again argued (1) that the documents were not relevant because the Commission had relied only upon "full bread line figures" when it issued the complaint; and (2) that the documents could not in any event establish that Continental [108] "knowingly sold below cost with intent to injure and destroy competition and competitors" because it did not know what its individual variety costs were when it marketed the products.[178]

On June 29, 1977 the Commission denied Continental's appeal, concluding that the issue certified did not warrant interlocutory review.[179] Shortly thereafter, on July 8, 1977 Continental notified the ALJ that it would provide all of the documents at issue; however, complaint counsel argued in response that Continental's offer should be declined. Continental nevertheless collected the responsive documents and tendered them to complaint counsel; on September 9, 1977 complaint counsel refused to accept them.[180] In September Continental moved to set aside the sanctions order, with the understanding that it would provide the subpoenaed documents. In November the ALJ denied the motion.[181] Continental again moved for rescission of the sanctions order in July, 1979, at the conclusion of the case in [109] chief, noting that complaint counsel could present the evidence during their rebuttal case and that Continental would waive "any right to present rebuttal evidence on the matter."[182] Complaint counsel once again opposed the motion, and the ALJ subsequently denied it.[183]

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[176] Order Imposing Sanctions (March 22, 1977), at 2 (citations omitted). The order defines "bread" to include white pan bread, bread type rolls, and related products, and describes each "geographic market" as "the location of an ITT Continental bread plant" and the area surrounding it. *Id.* nn.2,3.

[177] Order Allowing ITT-Continental's Appeal Of Order of February 16, 1977 (March 23, 1977). The ALJ did not certify the questions of the validity of Section 3.38 of the Commission Rules of Practice or the propriety of the underlying subpoena.

[178] Application For Review Of Ruling Of Administrative Law Judge (March 30, 1977) at 3–4. Continental also argued that compliance with the subpoena would be costly and time-consuming. Complaint counsel later indicated that simply analyzing the data in the subpoenaed forms would require "a minimum of a year" after the material had been supplied. Complaint Counsel's Response To Show Cause Order (Sept. 29, 1977), at 2 n.**.

[179] Order Denying Application For Review (June 29, 1977), at 2.

[180] Motion To Set Aside Orders Granting Application And Imposition Of Sanctions (Sept. 30, 1977), at 2; Answer To Respondent's Motion To Set Aside Orders (Oct. 14, 1977), at 4.

[181] Order Denying Motion To Set Aside Orders Granting Application For And Imposition of Sanctions Under Section 3.38 of the Commission's Rules of Practice (November 7, 1977). The ALJ later denied Continental's subsequent motion for an interlocutory appeal of his order. Order Denying Respondents' Request For Interlocutory Appeal (November 28, 1977).

[182] Respondents' Motion To Rescind "Order Imposing Sanctions" Of March 22, 1977 (July 16, 1979), at 10–11.

One last incident involving the documents covered by the sanctions order occurred the following year. In March, 1980, after Continental had concluded its defense case, complaint counsel served an extensive subpoena on Continental to secure evidence for its rebuttal case. Specification 32 of that subpoena sought documents "sufficient to show the Company's profits or losses on white pan bread alone" for most of Continental's bakeries during the 1969–1979 period.[184] Although Continental moved to quash the subpoena, it offered the documents covered by the sanctions order to partially comply with Specification 32, and delivered them to complaint counsel on March 24, 1980. Complaint counsel refused to accept the documents and later returned them, arguing that the documents were not responsive because they related to costs rather than profitability, and that [110]

> it would be patently absurd for us inadvertently to abandon the adverse inferences upon which we have relied for four years. We did not intend to do so. Moreover, if Mr. Wachter's critique can only be met at that price, we shall forego the luxury.[185]

Complaint counsel simultaneously filed an application to modify the subpoena by waiving production of the documents covered by the sanctions order.[186] On April 15, 1980 the ALJ granted Continental's motion to quash in part and struck most of the subpoena specifications, including Specification 32.[187]

The current significance of the adverse inferences that the sanctions created is somewhat unclear. The ALJ briefly described the sanctions order in his opinion, but did not rely upon any inferences derived from that order in reaching his decision. *See* ID at 3–4. In their appeal brief, complaint counsel refer to the adverse inferences in the sanctions order as "an alternative ground of support for the conclusion that respondents sold below average variable cost." CAP at 6 n.4. In their answering brief, complaint counsel argue that "The adverse inferences in this [111] case, CCPF 2–7, are a sufficient ground for finding predatory conduct and intent."[188] Finally, in the oral argument before the Commission, complaint counsel indicated:

> At this stage of the case we rely on one element of that [sanctions] order, that Continen-

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[183] Order Denying Respondents' Motion To Rescind "Order Imposing Sanctions" Of March 22, 1977 (September 28, 1979).

[184] Complaint Counsel's Application For Issuance Of A Subpoena Duces Tecum To ITT Continental (March 7, 1980) (Instructions), at 17.

[185] Motion To Modify Order Of March 22, 1977 And To Admit RX 125 (March 28, 1980), at 2–3; Complaint Counsel's Opposition To Motion To Quash March 1980 Subpoena (April 7, 1980), at 15–16; Response To Motion To Modify Order Of March 22, 1977, And To Admit RX 125 (April 9, 1980), at 3–4.

[186] Application To Modify March 1980 Subpoena To ITT Continental Baking Company, Inc. (April 7, 1980), at 2.

[187] Order Limiting Complaint Counsel's Discovery As To Their Case-In-Rebuttal (April 14, 1980).

[188] CAB at n.1; *see also id.* at 28 (relying upon CPF 2–7, *inter alia,* in an effort to show sales at prices below average variable cost), 43.

> tal should not be allowed to rely on documents they did not produce to [complaint] counsel. On that ground the cost study Mr. Schafer attempted to introduce [RX 125], [was] properly held out, only certain portions were allowed in. Judge Brown did not rely on the adverse inferences relied upon by Judge [Hinkes].[189]

In short, although complaint counsel relied extensively upon the adverse inferences prescribed by the sanctions order in their briefs to the ALJ, they appear to have reduced that reliance to some degree during the appeal phase of this proceeding.

The adverse inference rule upon which the sanctions order in this case relies

> provides that when a party has relevant evidence within his control which he fails to produce, that failure gives rise to an inference that the evidence is unfavorable to him.[190]

The power of federal courts to impose discovery sanctions such as adverse inferences pursuant to Rule 37(b) of the Federal Rules of Civil Procedure is well established. Most courts have sustained an analogous power on the part of federal administrative agencies [112] to draw adverse inferences from the failure to produce relevant evidence and the Commission has adopted that position with respect to its own adjudications.[191] If the evidence at issue has been subpoenaed and the party involved declines to comply with the subpoena in order to suppress the evidence, that may strengthen the adverse inference to be drawn from the failure to provide the subpoenaed material.[192] By contrast, the inference may be weakened by a strong alternative explanation for the failure to provide subpoenaed material, such as an effort to avoid the public disclosure of trade secrets for which one or [113] more patents are pending.[193] Administrative agencies may also prohibit an entity that deliberately withholds relevant subpoenaed material from relying upon that material in its own presentations.[194] The central purpose of these sanctions is to "maintain the integrity of the hearing process."[195]

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[189] Oral Argument Transcript at 33–34.

[190] *International Union (UAW)* v. *NLRB*, 459 F.2d 1329, 1336 (D.C. Cir. 1972).

[191] *P.R. Mallory & Co.* v. *NLRB*, 400 F.2d 956, 959 (7th Cir. 1968); *NLRB* v. *A.P.W. Products Co.*, 316 F.2d 899, 903–04 (2d Cir. 1963); *NLRB* v. *Wallick*, 198 F.2d 477, 483 (3d Cir. 1952); *NLRB* v. *Remington Rand, Inc.*, 94 F.2d 862, 868 (2d Cir.), *cert. denied*, 304 U.S. 576 (1938); *Market Development Corp.*, 95 F.T.C. 100, 223–27 (1980) (dictum); *American Medical Association*, 94 F.T.C. 701, 1027–29 (1979), *aff'd*, 638 F.2d 443 (1980), *aff'd by an equally divided Court per curiam*, 455 U.S. 676 (1982). *But see NLRB* v. *International Medication Systems, Ltd.*, 640 F.2d 1110, 1115–16 (9th Cir. 1981).

This conclusion is not inconsistent with the more general principle that administrative agencies cannot compel obedience to compulsory process by imposing fines or imprisonment. *ICC* v. *Brimson*, 154 U.S. 447, 485 (1894). Discovery sanctions such as adverse inferences are considerably different from the imposition of fines or imprisonment through the contempt power because they do not actually compel the production of subpoenaed materials. They simply give the subpoenaed party the option of either complying with the subpoena or facing the adoption of adverse inferences. If the party chooses the latter course, it will not suffer any injury unless an order is subsequently entered against it on the basis of the inferences involved, and it can secure judicial review of the propriety of the inferences on appeal.

[192] *International Union (UAW)* v. *NLRB*, 459 F.2d at 1338. *But see NLRB* v. *International Medication Systems, Ltd.*, 640 F.2d at 1115 n.3.

[193] *Evis Mfg. Co.* v. *FTC*, 287 F.2d 831, 842–47 (9th Cir.), *cert. denied*, 368 U.S. 824 (1961); *but see Charles Of The Ritz Dist. Corp.* v. *FTC*, 143 F.2d 676, 678 (2d Cir. 1944).

Rule 3.38(b) of the Commission Rules of Practice provides in relevant part that an Administrative Law Judge or the Commission may impose sanctions such as those imposed in this case when a party fails to comply with (1) a subpoena, (2) an order for the production of documents, or (3) an order issued by the Commission or an ALJ as "a ruling upon a motion concerning such an order or subpoena or upon an appeal from such a ruling . . ." The Rule indicates that the Commission or an ALJ [114] may impose these sanctions to permit the "resolution of relevant issues and disposition of the proceeding without unnecessary delay . . ." The Commission has developed some more specific principles to help determine when one or more of these sanctions should be applied. In *American Medical Association*, the Commission stated:

> Application of the adverse inference rule may only be made when the party's failure to produce documentary or other evidence is not adequately explained. Thus, the adverse inference rule makes the conduct of the person withholding the material an evidentiary fact in and of itself. The resulting inference may be strong or weak, depending on the person's conduct and the surrounding circumstances. For example, an inference drawn against a respondent offering a weak explanation for its refusal to produce relevant evidence will be stronger than an inference drawn against a respondent providing a more plausible explanation.[196]

The Commission concluded that the Administrative Law Judge had properly adopted an adverse inference against the respondent for failing to supply certain subpoenaed materials. The Commission noted that it was highly unlikely that the AMA's jurisdictional challenge to the subpoena—directed at its principal defense—would succeed, and that the AMA, despite its jurisdictional doubts, had nevertheless complied with every other subpoena issued in the case. In conjunction with the absence of "a strong [115] explanation for noncompliance," these facts persuaded the Commission to conclude that the adverse inferences had been properly drawn.[197]

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[194] *NLRB* v. *C.H. Sprague & Son Co.*, 428 F.2d 938, 942 (1st Cir. 1970). The Court noted that this conclusion might not have been valid if the company had taken the position "that all the information sought by the subpoena was irrelevant." *Id.* However, the firm had admitted that the requested information was relevant, and had offered no justification for failing to comply with the subpoena. *Id.*

Administrative agencies may also decline to permit a firm that withholds subpoenaed material from later producing secondary evidence to prove what could have been conclusively established if the subpoena had been honored. *NLRB* v. *American Art Industries, Inc.*, 415 F.2d 1223, 1229–30 (5th Cir. 1969), *citing Bannon Mills*, 146 N.L.R.B. 611 (1964); *but see NLRB* v. *International Medication Systems, Ltd.*, 640 F.2d 1110, 1115–16 (9th Cir. 1981).

[195] *NLRB* v. *American Art Industries, Inc.*, 415 F.2d 1223, 1230 (5th Cir. 1969); *accord, NLRB* v. *C.H. Sprague & Son Co.*, 428 F.2d 938, 942 (1st Cir. 1970); *International Union (UAW)* v. *NLRB*, 459 F.2d 1329, 1338 (D.C. Cir. 1972).

[196] *American Medical Ass'n*, 94 F.T.C. at 1027; *accord, Market Development Corp.*, 95 F.T.C. at 226 (dictum).

More recently, in *Grand Union*, the Commission elaborated upon its earlier analysis to conclude that sanctions under Rule 3.38 should be imposed only if (1) production of the requested material has been mandated by a subpoena or specific discovery order issued by an ALJ or the Commission and directed at the party (or its officer or agent) from whom the material is sought; (2) the party's failure to comply is unjustified; and (3) the sanction imposed "is reasonable in light of the material withheld and the purposes of Rule 3.38(b)."[198] The Commission noted with respect to the third requirement that "[a]n adverse ruling is a severe sanction to be imposed only in extraordinary circumstances."[199] The Commission agreed with the ALJ that adverse inferences against complaint counsel would have been inappropriate because the delay in furnishing certain information to the respondents had been the product of a misunderstanding, and complaint counsel had made a good faith effort to disclose all requested data to the respondents as they became aware of it.[200] **[116]**

The foregoing principles have led the Commission to conclude that it should not rely upon the adverse inferences that the ALJ prescribed in his sanctions order in this case. In this sort of situation, Rule 3.38 should be interpreted to permit the party that fails to supply the required documents to tender them within a reasonable period of time *following* the issuance of an order imposing sanctions. Prior to that time, a party that elects to contest portions or all of an order for the production of documents or other materials does not know whether the ALJ or the Commission will in fact impose some or all of the available sanctions, modify the terms of the subpoena or order, or instead apply to a district court for enforcement.

This approach would be consistent with the procedure adopted in *International Union*. There, the Court of Appeals confronted a respondent in an NLRB proceeding that had for seven years refused to provide clearly relevant documents in response to an NLRB subpoena. The Court of Appeals nevertheless directed the NLRB to draw an adverse inference from that failure to produce only if the respondent failed to produce the documents at issue within thirty days after the entry of the Court's order.[201] The court indicated that

> in order to be absolutely certain that no miscarriage of justice occurs, we think the company should be given one last chance to come forward with the documents. Now that the consequences of suppression have been made abundantly clear, surely Gyro-

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[197] *American Medical Ass'n*, 94 F.T.C. at 1028.

[198] *Grand Union Co.*, 3 Trade Reg. Rep. (CCH) ¶22,050 (July 18, 1983) at 22,731.

[199] *Id.* at 22,732.

[200] *Id.* at 22,730–22,731.

[201] *International Union (UAW)* v. *NLRB*, 459 F.2d at 1347–48.

> dyne will produce the rehiring records if they are in any way exculpatory. If the company still prefers [117] suppression—even at the price of having its cost-cutting defense stricken—then the tenor of the documents will be obvious to all.
>
> By permitting Gyrodyne a last chance to come forward with the documents, however, we do not mean to suggest that the proceedings may be delayed indefinitely while Gyrodyne ponders its decision. We have seen quite enough pondering—and not nearly enough deciding—already. Therefore, the Board should allow the company 30 days to produce the rehiring records. If, by the end of that time the company has still not come forward with the evidence, the consequences outlined above should swiftly follow.[202]

In this case, the ALJ simply imposed the sanctions at issue without giving Continental the alternative of tendering the disputed documents within a limited period of time—thirty days would probably have been a useful maximum—after the finalization of his order. The ALJ then certified for appeal to the Commission the policy question of whether the Commission should rely upon his adverse inferences or should instead seek federal district court enforcement of the subpoena at issue. Once the Commission determined that interlocutory appeal of the ALJ's order was not appropriate, and remanded the issue to the ALJ, Continental immediately tendered the disputed documents. Nevertheless, the ALJ refused to withdraw the adverse inferences entered earlier, and instead permitted complaint counsel to refuse to accept the disputed documents. The ALJ should have permitted Continental to tender the disputed documents within thirty days after the Commission denied Continental's appeal, and should have withdrawn the adverse inferences once Continental did [118] so.[203] That approach would have provided a better resolution of the cost issue than the sanctions order, and the purpose of Rule 3.38(b) is after all to induce parties to supply subpoenaed material. We should note that if the ALJ had prescribed an additional time period within which to tender the subpoenaed documents, and Continental had refused to supply them within that time period, then reliance upon the ALJ's sanctions order—to [119] determine in particular that Continental sold bread at prices below average variable cost—would have been entirely appropriate.[204]

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[202] *Id.* at 1348.

[203] This is not to suggest that an ALJ order adopting discovery sanctions must always be certified for appeal to the Commission. The Commission Rules give ALJs the authority to determine the proper scope of discovery orders, and to impose sanctions for failure to comply with such orders when appropriate; certification will be appropriate only in unusual circumstances. If an ALJ does not certify the imposition of discovery sanctions to the Commission for appeal, then the party involved would be required to provide the subpoenaed materials within thirty days or some other possibly shorter prescribed period after the entry of the ALJ's sanctions order in order to have the sanctions withdrawn.

Continental's explanations for its behavior, which are described above, might conceivably weaken the strength of the inferences to be drawn from Continental's failure to produce the subpoenaed documents to some degree. However, we need not resolve that issue because of our determination that the procedure for imposing the sanctions should have been modified. We do note that ALJs are quite capable of resolving relevance questions relating to discovery orders, and we urge them to do so as expeditiously as possible.

[204] Permitting a short period such as thirty days within which required documents may be tendered after the entry of a sanctions order need not necessarily delay Commission adjudicative proceedings. The Commission Rules

(footnote cont'd)

The discovery sanctions set forth in Rule 3.38(b) represent a legitimate and necessary procedure, and the Commission will vigorously apply them when necessary to remedy an unjustified failure to comply with a valid subpoena or other discovery order. The Commission has, however, determined for procedural reasons not to rely upon the adverse inferences in the ALJ's sanctions order in this case.

V. CONCLUSION

The Commission has concluded that Continental did not violate Section 5 of the Federal Trade Commission Act or Section 2(a) of the Clayton Act. The Commission has therefore determined to dismiss the complaint in this matter in all respects.

COMMISSIONER PATRICIA P. BAILEY, CONCURRING IN PART AND DISSENTING IN PART*

After I presented the draft of this opinion to the Commission for consideration, it became clear that the Commission was unanimous in its view as to the disposition of most of the case. That is, regardless of the cost standard used to define "predatory pricing," those parts of the case involving St. Paul/Minneapolis, Denver, Northern California and Southern California, should be dismissed for failure to establish a violation of either Section 2 of the Sherman Act or Section 2(a) of the Robinson-Patman Act.

A majority of the Commission, however, disagreed with the cost standard contained in my draft and therefore disagreed also with that section of the draft involving Cleveland because the standard presented resulted in a finding of Robinson-Patman primary line liability in that market.

Thus, I concur in the opinion of the Commission in this case with respect to the dismissal of all Sherman Acts charges and all Robinson-Patman charges outside of Cleveland, although I do not necessarily ascribe to various modifications as to nuance and emphasis in those portions of the opinion. In particular, as I stated in connection with the final decision in *General Foods Corporation*, Docket 9085 [103 F.T.C. 204 (1983)], I do not agree that product differentiation is only rarely an entry barrier. Nor do I see the necessity for a lengthy discussion of national market trends when the focus of the case is on local markets. [2]

The crux of my dissent concerns the question of how to distinguish

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currently permit parties to file motions to quash subpoenas and other discovery orders, and delay compliance with those orders until the motions have been ruled upon. If an ALJ felt such a procedure to be appropriate, he or she could, consistent with the rules, prescribe sanctions for the failure to produce subpoenaed materials within a prescribed period at the same time that he or she denies a motion to quash the subpoena or other order at issue.

* Commissioner Pertschuk joins in this separate statement.

a predatory price from a legitimate competitive price. The majority's approach is too rigid and, as we are dealing with a still developing and controversial area of law, their approach is prematurely strict.

Predatory Pricing

Few issues in antitrust law have produced such a gallimaufry[1] of economic theory and legal precedent. Since 1975 there has been "a virtual explosion in the legal and economic literature dealing with predatory pricing." Brodley & Hay, *Predatory Pricing: Competing Economic Theories and the Evolution of Legal Standards,* 66 Cornell L. Rev. 738, 740 (1981). At least nine different economic theories for detecting predation have been advanced,[2] and the courts have been both selective and [3] idiomatic in applying these tests.[3] In these circumstances it is neither fruitless nor presumptious for the Commission to forge its own rule. However, that rule should be a flexible, cautious one, capable of assimilating new learning on the subject and avoiding excessive leniency or harshness to either plaintiffs or defendants. The majority's approach, it seems to me, is less an analytical tool than a conclusory statement which can fairly be characterized as follows: price discriminations are either harmless or justified, thus, price predation does not exist. I cannot share their confidence on this point; nor do I believe there would be such an outpouring of academic and judicial debate if the issue were all that clear.

Accordingly, my approach, described more fully below, would be a phased series of structural and firm-specific inquiries, incorporating a cost-price benchmark for legality which varies [4] depending on the circumstances of the case. While I agree with the majority that prices above average total cost (ATC) are legal, I disagree strongly with the "often conclusive" presumption of legality they assign to prices below ATC but above average variable cost (AVC). As my analysis of the Cleveland market demonstrates, I believe such prices can be predatory, particularly as they approach the AVC line and if they continue for some time. On the other hand, in some market conditions prices in the zone between ATC and AVC can be legitimate. Therefore, looking at the facts of each case rather than relying on near-conclusive presumptions is, for me, the only responsible way to decide the issue. Finally I would attach a much stronger presumption of illegality to prices below AVC than does the majority; I would limit the number of excuses for pricing at that level, and I suspect I would find the conduct to have anticompetitive effects after a much briefer predatory pricing incident than the majority.

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[1] "This is one of the greatest Gally-maufries that ever I saw; but it was intended as an Antidote against Plague." Salmon, *Pharm.* (1678)

[2] The seminal discussion recommended a short-run marginal cost pricing rule using average variable cost as a practical surrogate for marginal cost. Areeda & Turner, *Predatory Pricing and Related Practices of Section 2 Under the Sherman Act,* 88 Harv. L. Rev. 697 (1975). This proposal was challenged for disregarding the risk that a dominant firm can successfully pursue a strategy of sacrificing short-term profit for long-term benefits in order to exclude actual or threatened competition. Scherer, *Predatory Pricing and the Sherman Act: A Comment,* 89 Harv. L. Rev. 869 (1976) (offering an economic model for testing cost based rules and suggesting a broad rule-of-reason approach). Other commentators proposed long-run pricing rules that emphasized different cost factors. R. Posner, *Antitrust Law: An Economic Perspective,* 184-196 (1976) (presumptively condemning sales below average total cost with intent to exclude a competitor); Joskow & Klevorick, *A Framework for Analyzing Predatory Pricing Policy,* 89 Yale L.J. 213 (1979) (proposing a two-tier test: only if monopolistic conditions exist in the market may pricing below the average variable cost be conclusively illegal, or pricing below average total cost be presumptively illegal under specified conditions). Other economists recommend approaches focusing on output changes or the timing of price cuts. Williamson, *Predatory Pricing, a Strategic and Welfare Analysis,* 87 Yale L.J. 284 (1977) (barring dominant firms from expanding output or selling below full cost to forestall entry); Baumol, *Quasi-Permanence of Price Reductions: A Policy of Prevention of Predatory Pricing,* 89 Yale L.J. 1 (1979) (barring price increases by a dominant firm for a specified period after its price cuts drive competitors from the market). Although not proposing a specific legal standard, two commentators have drawn attention to the prerequisites for successful entry-deterrance conduct. Salop, *Strategic Entry Deterrance,* 69 Am. Econ. Rev. 335 (1979); Spence, *Entry, Capacity, Investment and Oligopolistic Pricing,* 8 Bell J. Econ. 534 (1977). And finally, at least one commentator has argued that there should be no standard at all, since no problem exists. R. Bork, *The Antitrust Paradox* 154 (1978).

[3] Hurwitz & Kovacic, *Judicial Analysis of Predation: the Emerging Trends,* 35 Vanderbilt L. Rev. 63 (1982).

Aside from the use of near conclusive presumptions, the majority's tests are no more efficient than the one I propose: cost definitions must be made under either. We are in agreement on the propriety of the "leap-frog" analytic technique as announced in *General Foods Corp,* D. 9085 [103 F.T.C. 204 (1983)]. That is, we all agree on avoiding the time and resource-consuming quagmire of cost-based pricing rules if easier preliminary inquiries reveal that below cost pricing either could not result in successful predation or is shielded by a legal defense. Therefore, I would first examine competition in the alleged market to see whether [5] and what kind of predation is possible. The existence of entry barriers and the strength of respondent's market power are significant factors. Also important are the level of capacity in the market and duration of the alleged predatory incident.

I believe that the relevant measure of capacity utilization is that of the market and not that of the respondent because, in order to predate, a firm must always have some excess capacity. Zerbe and Cooper, *An Empirical and Theoretical Comparison of Alternate Predation Rules,* 61 Texas L. Rev. 655, 682 (1982). Otherwise, it cannot serve its rival's former customers when exit is induced. Thus, finding that the respondent has excess capacity may not be exculpatory. However, if capacity utilization is very low throughout the market, competitive market conditions may have forced respondent to price at or below its short term marginal costs in a desperate effort to avoid the even greater losses of temporarily closing or leaving the market altogether.[4] On the other hand, where the market does not face substantial excess capacity, pricing below marginal cost begins to look suspect, because competition should force prices to at least that level. (Areeda

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[4] *See, e.g.,* Williamson, *supra,* 87 Yale L.J., 284 (1977); *William Inglis & Sons Baking Co. v. ITT Continental Baking Co.,* 461 F.Supp. 410, 418-19 (N.D. Cal. 1978), *aff'd in part and rev'd in part,* 668 F.2d 1014 (9th Cir. 1981), *cert. denied,* 103 S.Ct. 57 (1982); *ILC Peripherals Leasing Corp. v. IBM Corp.,* 458 F.Supp. 423 (1978), *aff'd per curiam sub nom. Memorex Corp. v. IBM Corp.,* 636 F.2d (9th Cir. 1981), *cert. denied,* 452 U.S. 972 (1981)

& Turner, *supra*, 88 Harv. L. Rev. at 702) The inference is that prices were lowered, not in response to competition, but rather in anticipation of their destructive [6] effect upon competitors and consequent enhanced market position of respondent.

Having established the competitive setting, I would then determine the relevant measure of cost. There is a general consensus that pricing below marginal cost gives rise to a presumption of illegality.[5] There is much argument, however, on what accounting definition of cost is the proper evidentiary surrogate for that elusive economic benchmark, which is not recorded on a firm's business records. Some courts and commentators have suggested that a company's prices be compared to its average total cost (ATC);[6] others have suggested average variable cost (AVC);[7] still others have suggested a middle course.[8] In my view, no one cost standard is always appropriate; [7] rather, the market setting dictates the choice. Price below ATC can be predatory where there is a high level of capacity utilization in the market, and pricing below AVC is presumptively predatory. For me, the presumption against legitimate prices below AVC is very strong,[9] but could be rebutted by a showing of excess market capacity as discussed above. Furthermore, I would take the duration of the alleged predatory incident into consideration. When the more lenient ATC standard is used, the low prices must endure for some significant period of time. As the price level approaches AVC, however, the scope of harmful duration may be shortened. When price falls below AVC an even shorter span of low pricing may be deemed potentially harmful. Of course, the presumptions of harm to competition derived from the level and duration of the price reduction ultimately must be tested against any evidence the record may contain about actual impact of respondent's conduct upon competition.[10] Thus, if it is clear from a preliminary examination of the record that the market continued to function competitively after the alleged predatory incident, the case may be dismissed without tracing the elaborate steps of the cost-price quadrille.

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[5] *See generally*, Areeda & Turner, *supra*, 88 Harv. L. Rev. at 712, 733.

[6] Posner, *supra; Transamerica Computer Co. v. IBM Corp.*, 698 F.2d 1377 (9th Cir. 1983) (prices *above* ATC are not *per se* lawful, but plaintiff must prove predation by clear and convincing evidence), *cert. denied* 104 S.Ct. 370 (1983); *but see Barry Wright Corp. v. ITT Grinnell Corp.*, 1980–81 Trade Cas. ¶63,862 (D. Mass. 1981) *aff'd* 1984–1 Trade Cas. ¶65,787 (1st Cir. 1983) (prices above ATC conclusively lawful).

[7] Areeda & Turner, *supra; Northeastern Telephone Co. v. AT&T Co.*, 651 F.2d 76 (2d Cir. 1981), *cert. denied*, 455 U.S. 943 (1982); *International Air Industries Inc. v. American Excelsior Co.*, 517 F.2d 714 (5th Cir. 1975), *cert. denied*, 439 U.S. 829 (1978).

[8] Zerbe and Cooper, *supra* (compare prices to ATC unless excess capacity exists; in that case, compare to AVC); Joskow and Klevoric, *supra*; and *compare* William Inglis & Sons Baking Co. v. ITT Continental Baking Co., supra (price below ATC is predatory if accompanied by other proof of predatory intent) with *MCI Communications Corp. v. AT&T*, 708 F.2d 1081 (7th Cir.), *cert. denied*, 104 S.Ct. 234 (1983) (conclusive presumption of legality for prices exceeding long-run incremental costs; very little weight attached to subjective evidence of intent).

[9] Areeda & Turner would make it a conclusive presumption, 88 Harv. L. Rev. at 733, as do Joskow and Klevoric, under specified market conditions, 89 Yale L.J. at 252.

[10] Post-predation evidence is not a necessary element of a predation case, but often exists, given the slow process of antitrust litigation, as in this case. Where it appears in the record, it should be considered.

I agree with the majority that the issue of pricing below cost is reached in only one of the five markets examined in this [8] case. The Sherman Act counts cannot survive in any city, once a market definition including captive bakers is accepted. I agree that the Robinson-Patman counts are dismissed because of a valid meeting competition defense in Northern California, and lack of data from which to generate accurate cost-price comparisons in Southern California and St. Paul/Minneapolis. In these last two markets I would add my own conclusion that there has been a demonstrable lack of anticompetitive effects. In both markets the sum total of competitors remained practically unchanged after the alleged predatory incidents.

In the Denver market I would dismiss the Robinson-Patman count on the grounds of a valid cost-justification defense. Virtually the only cost data in the record is contained in an accounting study prepared by Continental for the *Old Homestead* litigation. That study shows that for the last eight weeks of 1967 Continental priced the one pound Tender Crust bread loaf below average variable cost. Setting aside the questions of whether the one pound loaf is an adequate vehicle for predation and whether an eight week period is sufficiently long for effective predation, and assuming, *arguendo*, that the study is entirely free from methodological error,[11] the case for predatory [9] intent must still fail. Whatever else it may prove, the *Old Homestead* study clearly shows that the difference in price between Tender Crust and Wonder products was cost justified.

Advertising expenses are a specific line item on the cost study: Wonder Bread had known advertising expenses, while Tender Crust, as a private label brand, had none. The *Old Homestead* cost study consistently shows (1964–1969) that costs of advertising Wonder exceeded the price difference between Tender Crust and Wonder, even when discounts are included in the calculation.[12] The study also shows other specific costs which are generally higher for Wonder than

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[11] Complaint counsel are in the anomalous position of urging that CX 1728, which shows sales above fully allocated costs for 1964 through October, 1967, be disregarded because of faulty methodology—except as it pertains to the last eight weeks of 1967, when sales below average variable cost are shown. (CCAB, 62)

In brief, complaint counsel contend that respondent erred in allocating production costs between Tender Crust and Wonder Bread on the basis of sales price. (CX 1722U–X, Z) For purposes of this allocation, the sales price was assumed to be the same for Wonder as for Tender Crust, in recognition of the fact that the two labels surround identical products. Complaint counsel would have allocated costs "in proportion of units, weights and values". (Memorandum in Support of Complaint Counsel's Application for Sanctions Under Rule 3.38, December 29, 1976, p. 9) For Robinson-Patman purposes we need not decide between these allocation methods, since both sides apparently agree that Wonder and Tender Crust should have identical amounts of allocable costs assigned to them, under any allocation method. Thus all non-specifically allocable expenses cancel out and can be bypassed when evaluating the cost justification defense, which rests on specific expenses, as described above.

[12] The ALJ incorrectly stated that CX 1728 does not show discounts on Tender Crust. (IDF 83; ID at 86) It does show such discounts, on the line headed "Other Selling Expenses." (CX 1722Z–5)

Tender Crust, such as returns and route labor;[13] but the high advertising costs alone can establish a complete cost justification defense. Indeed, it [10] is clear that throughout the relevant period Continental made more money on Tender Crust, or at least lost less in loss periods, than it did on the Wonder label. Since the price differentials were cost-justified, I would dismiss the Robinson-Patman case. This leaves Cleveland as the only market in which to demonstrate our differing approaches. My analysis is as follows.

Cleveland

In this market between 1973 and 1977 ITT-Continental allegedly captured and kept, by means of below cost sales, a large private label white pan bread account, thus causing primary line competitive dislocations which were still observable in 1980.

The preconditions for predation were certainly present in the Cleveland area in the early 1970's. The record shows no new entry between 1970 and 1980, a decade which reaches significantly before and beyond the alleged predatory conduct. On the eve of the incident, almost no baker serving the market had excess production capacity. Millbrook and Ward's, the first and second-ranked wholesale bakers were both running at least two full shifts a day. (IDFs 290, 308) Other bakers were similarly at full capacity, according to several witnesses, including Joseph Signore, Continental's then-Regional Vice President. (Bateman Tr. 5775; Gase Tr. 9375–76; Signore Tr. 9989–90, 10051) The exception was Continental, whose white pan bread plant at Akron was operating at only 50%–60% of capacity (1 1/4 shifts). (IDF 300) [11]

Joseph Signore, the chief architect of Continental's drive to secure the aforementioned private label contract, recognized that Continental's unique under-capacity situation could be used not only to win the private label account, but also to make Continental the "dominate [sic] factor on the market." (CX 2683B).

In these circumstances, I would infer predatory intent and effect from sales below fully allocated cost (FAC)[14] even if sales were not below average variable cost. The place I find such sales is in the private label contract which Continental negotiated with Pick'N'Pay (PNP), a major grocery store chain in the Cleveland area. That contract was signed on July 13, 1973, and amended September 25, 1974. (IDFs 311, 328) The record contains a variety of data (cost studies, analyses and monthly sales reports) by which the profitability of the contract may be tracked from its inception through August 1977.[15]

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[13] The full rack service offered with Wonder Bread included pick-up of stale bread; no pick up of returns was offered in the private label program. (CX 1722Z–4) Because of a union contract, bakers paid lower commissions to route salesmen on private label bread than they did on advertised label bread. (CX 1722Z–43)

[14] Fully allocated cost, sometimes called full cost, is used as a surrogate for average total cost in this case because Continental's records did not show ATC, an economic concept which in essence is FAC plus a normal return on investment. FAC is thus a more lenient proxy for marginal cost than is ATC. (Areeda & Turner have noted that normal return on investment is "a figure usually not determinable with any precision." 88 Harv. L. Rev. at 709)

Nevertheless there are further definitional questions about the PNP contract which must be answered before one can determine if white pan bread was sold below cost. The written agreement [12] (CX 803) was not the full extent of Continental's obligations. There were also a variety of "side bar" agreements to lease PNP's trucks, racks, and dollies and rent the PNP warehouse for the early months of the contract. Continental negotiators made such obligations contemporaneously with the formal, written contract and Continental honored those obligations. (IDFs 313, 314) Therefore, where the Continental internal cost studies assign these costs to the account (*e.g.*, CX 2680) I have included these costs in my calculations.

A second issue concerns what costs should be considered variable under the PNP contract. The appeal briefs set up quite a conflict on this point, with complaint counsel arguing that virtually all selling and distribution costs are variable, and respondents' counsel asserting that sales commissions are the only truly variable selling expense. However, Continental's internal cost studies belie the theories of respondents' counsel. Uniformly these studies, supported by testimony of Continental's employees, describe almost all selling and distribution costs as variable. (*See, e.g.*, Gase Tr. 9421–22; RX 309; CX 2661). Accordingly, I have taken the Continental's variable cost calculations as given, and have not subtracted out such items as sales management and vehicular costs, as respondents' counsel advocate.

I have, however, included in my cost calculations one variable not shown in the primary Continental cost records. As noted, Continental made many auxiliary, verbal commitments to the July 13, 1973, written agreement with PNP. (IDFs 313, 314) One [13] was to reimburse PNP for promotions of private label products. (IDF 313). While these payments were known to the Continental management level, they were not disclosed to the accountant who prepared the line profit studies. (Vail Tr. 9971–72, 9981–82; Schmidt Tr. 11163–64; CX 2626A, N, O) Accordingly these studies lack that item. While respondents' counsel made no attempt to argue that the promotional payments are a fixed cost[16]—indeed, the payments are classic examples of a variable cost, since they fluctuate directly with changes in output—they nevertheless made no effort to correct the incomplete contemporaneous variable profit calculations. Such adjustments can be made, since the amount of promotional payments is known. (CX 2682; Breines Tr. 11098–11100) They should be made, since the amount is significant: approximately $210,000 between July 1973 and April 1976. (IDF 313) I have made those adjustments.[17] [14]

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[15] The documents do not detail every month of the four year period, but summarize performance at irregular intervals, providing the nine data points which are referenced in the tables, *infra*.

[16] Continental may have had the option of incurring these costs in a lump sum, one-time fixed form as a purchase of PNP's bakery assets. (Vail Tr. 9968, 9972). The promotional payment obligation was subject to an outer limit of the estimated book value of those assets. (IDF 313) However, the fact that these costs could have been structured differently is speculative and irrelevant; no doubt other terms of the contract would have been different if Continental had committed to an upfront payment of $210,000. In the contract as performed, that sum was stretched over three years, and conditioned to bread output. Its effect on the cost of both the total contract and the white pan bread line was variable.

This brings me to the relevant cost calculations. It should be emphasized that they are based on the same documents which the ALJ used to reach his cost conclusions (IDFs 320–325, 347). My review, however, had to be more precise inasmuch as I neither accept his ruling that average variable cost (AVC) always amounted to 80% of fully allocated cost (FAC); nor would I find liability on the mere fact of sales below FAC. The degree by which costs of either type exceed prices must be closely observed.

My calculations are set forth in the following tables:

Table 1

Month(s) & Year	Price as a Percent of Average Variable Cost for White Pan Bread
June 1974	87.0%
January 1976	101.0%
January-March 1976	101.0%
July 1976	99.3%
August 1977	110.0%

Table 2

Month(s) & Year	Price as a Percent of Fully Allocated Cost for White Pan Bread
December 1973	Price below FAC on a per-unit basis for each white pan bread product, ranging from 99.99% of FAC to 91.0% of FAC, exclusive of promotion payments
May 1974	81.0%
June 1974	77.5%
December 1975	82.4%
January 1976	81.5%
January-March 1976	81.7%
July 1976	79.0%
August 1977	77.9% [15]

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[17] The promotional payments apparently were in support of the white pan bread products only. Therefore, in arriving at the cost figures for white pan bread products I attributed all of the promotional payments to those products.

Thus, between 1973 and 1977 Continental persistently priced far below FAC on the white pan bread items in the PNP contract. For four years the white pan bread price was consistently about 20% less than fully allocated cost. This deep a cut below FAC often approached the AVC level and twice fell below the AVC level. White pan bread was sold at such a loss that the entire private label contract never made a profit on a FAC basis during this time.[18] (IDF 347; Gase Tr. 9402) **[16]**

The inference of predation raised by cost data is confirmed by a survey of the marketplace before and after Continental won the PNP contract. In 1971 there were five strong independent bakers in the Cleveland market, plus a scattering of smaller bakers. The five top companies were of roughly equal strength, and there was no price leader among them. (IDF 299) Far from being the leader of the pack, Continental shared third rank with American. (IDF 296)

By 1980 Continental shared dominance of the market with Interstate. Those two were the acknowledged price leaders. (IDF 342) Laub, one of the top five firms in 1970 left the market completely after losing its PNP shelf space to Continental. (IDF 318, 341) American,

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[18]

Table 3

Month(s) & Year	Price as a Percent of Average Variable cost for the Private Label Account
August 1973	98.1%
December 1973	98.2%
May 1974	92.2%
June 1974	89.0%
January 1976	106.3%
January-March 1976	103.7%
July 1976	101.0%
August 1977	108.4%

Table 4

Months(s) & Year	Price as a Percent of Fully Allocated Cost for the Private Label Account
August 1973	98.6%
December 1973	Price below FAC on a per-unit basis for all but two low-volume varieties, therefore price below FAC for entire private label account
May 1974	86.1%
June 1974	79.8%
December 1974	84.5%
January 1976	83.9%
January-March 1976	82.6%
July 1976	79.6%
August 1977	81.7%

Continental's erstwhile head-to-head competitor, had slipped to sixth place, behind even Nickels and Schwebel, bakers which Continental's regional vice president assessed as "not strong factors, grocery-wise". (Gase Tr. 9533; IDF 342) The market is clearly less competitive in 1980 than it was in 1970.

Having determined that the PNP contract was predatory for as much as four years, I turn to the question of whether Continental has any recognizable defenses.

The tortured history of Continental's negotiations for the PNP private label account is ably set forth by the ALJ at IDFs 305–314. My reading of the record, which consists mainly of testimony of persons involved in both sides of the negotiations, convinces me that the ALJ correctly concluded that Continental has no "meeting competition" defense under Section 2(b) of the [17] Robinson-Patman Act.[19] (ID, p. 85) This is abundantly clear with regard to the renegotiated 1974 contract, as there is not the slightest evidence in the record that Continental believed its offers, which were still far below FAC, to be in good faith response to any competing offers. As for the original July 1973 terms, it appears that the prices were decreased and contractual obligations increased several times in the early part of the year, significantly after competing bidders' offers had lapsed and after Vail, Continental's vice president in charge of national accounts, became confident that Continental would become PNP's supplier of private label bread.[20] (IDFs 309, 310; CXs 803, 809, 839, 884)

A second defense which respondents raise in Cleveland is the argument that Laub was not harmed by the effects of the PNP contract. In other words, they argue that the causes of Laub's demise were business problems unrelated to Continental's low cost sales.

My examination of the record convinces me that Continental's conduct, though not the sole cause, was a major cause of Laub's closing. In the early 1970's Laub had been losing significant [18] restaurant business and some small grocery accounts, often to Continental;[21] but its overall business, especially the grocery side, was definitely operational. It had a fully automated, very efficient plant, an aggressive sales force, and the label rights to a nationally-recognized label, "Sunbeam bread". (Stonbraker Tr. 5529, 5563–66, 5598; Bronczek Tr. 5710–

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[19] It should be noted that, in Cleveland, any meeting competition defense is limited to the competing bids for the PNP contract. It is not an "area-wide" defense such as the Commission considers in the Northern California market.

[20] PNP originally was interested in dock delivery to its warehouse and received several bids on this proposition. (Kravitz Tr. 5394–95) However, when PNP changed its terms to store drop those bids were not renewed. (Kravitz 5393–95, 5408; Schwebel Tr. 5817; Bogolmony Tr. 5869; Bateman Tr. 5777 CX 884) Signore had only the most general belief that other companies might be in the running for the contract; after 1972 he was not aware of any specific competitive offers. (Signore Tr. 9993–9994, 10031)

[21] Complaint counsel devote some time to CBC's "potshotting" of Laub restaurant accounts; the Initial Decision also notes CBC's inroads here. (IDF 301–303) However, since the record contains no indication that these sales were won by predatory means, I have not considered these practices to be part of the case.

11) In 1973 Laub had approximately 54 grocery routes, which compares favorably with the 68 routes of Interstate, the market's then leading wholesale baker. (IDF 288; Stonbraker Tr. 5588)

In 1973, PNP was Laub's largest customer, and Laub's bread enjoyed the largest share of the branded portion of PNP shelf space. (Stonbraker Tr. 5590–91) As a result of the Continental contract, Laub's all-important white pan bread sales to PNP declined drastically. Laub's white pan bread products were simply edged off the shelf by Continental's private label and advertised brands. (IDFs 317, 318) Moreover, the loss of general exposure to consumers through the PNP stores also hurt Laub's sales through other outlets. (Stonbraker Tr. 5605–5606) The loss of volume associated with exile from the PNP stores had an immediate effect: Laub was forced to consolidate delivery routes, but even that cost-cutting measure was not enough to save the company and within six months the bakery had shut down. "You just can't go on when your volume is not there." (Stonbraker Tr. 5608) [19]

I think this chain of causality is fairly strong, and it becomes more so when we note that Interstate, though considerably larger and healthier than Laub, also suffered from losing PNP shelf space to Continental. (Meehan Tr. 5341) Clearly, the PNP account would be very important to any supplier, and its loss could be the final straw to a smaller bakery such as Laub.

Of course, actual injury and permanent loss of sales need not be proven to show a violation of the Robinson-Patman Act; but such facts are convincing evidence of a violation. *National Dairy Products Corp. v. FTC*, 412 F.2d 605 (7th Cir. 1969). Here Continental's long, deep cuts in the price of white pan bread create such a possibility of harm to competition that a violation of the act must be found, absent some showing that the probable effect did not take place. Respondents have not made such a showing. To the contrary: all the evidence in the record points to a market much less competitive now than it was a decade ago; with Continental's dominance unchallenged by either new entrants or existing competitors. Moreover, the loss of at least one independent baker seems directly related to Continental's predatory pricing between 1973 and 1977. Accordingly, I would have found that Continental's discriminatory prices on white pan bread in the Cleveland market from 1973 to 1977 caused primary line injury in violation of Section 2(a) of the Robinson-Patman Act.

Conclusion

The difference between my views on predation and that of the Commission majority was sketched out in my partial dissent to the *General Foods* opinion and earlier in my dissent to the decision [20] not to seek *certiori* in the *Borden (ReaLemon)* matter. The majority opts for a series of assumptions that places the danger zone well below AVC ("properly defined", of course). It is inconceivable to me that any firm could fail to show prices safely above this line, given the wealth of acceptable excuses listed by the majority, not to mention the requirement of a "significant," wholly continuous period of low prices. (Apparently four years—the time of below cost sales in Cleveland—is not "significant" enough).

The approach I have outlined is assailed principally because it is subject to accounting ledgerdemain. To this I answer, so is any test where the definition of cost is at issue.[22] I do freely admit to one of the criticisms leveled at my approach by the majority: it does not foster as much industry certainty as their AVC test. Certainly, my approach would require a modicum of structural and firm-specific inquiry. Nevertheless, I believe it is a practical, workable standard. In contrast, the majority's AVC test gives near absolute business certainty after one reading: in the words of Cole Porter, "Anything goes." It would be simpler, and surely a great saving of everybody's time, if the Commission today had simply announced that it does not believe predatory pricing exists.

FINAL ORDER

This matter has been heard by the Commission upon the appeals of complaint counsel and respondent from the initial decision and upon briefs and oral argument in support of and in opposition to the appeals. For the reasons stated in the accompanying Opinion, the Commission has determined to reverse the initial decision. Respondent's appeal is granted and complaint counsel's appeal is denied. Accordingly,

It is ordered, That the complaint is dismissed.

Commissioners Pertschuk and Bailey dissented in part and concurred in part.

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[22] For example, the majority would amortize promotional and advertising expenses over a product's goodwill life cycle (presumably established by the promotor's testimony as to his fondest expectations). If this isn't an arbitrary variable, fraught with accounting peril, what is?

IN THE MATTER OF

DIAMOND CRYSTAL SALT COMPANY

MODIFYING ORDER IN REGARD TO ALLEGED VIOLATION OF SECTION 7 OF THE CLAYTON ACT

Docket 7323. Final Order, Feb. 4, 1960—Modifying Order, July 30, 1984

This order reopens the proceeding and modifies the Commission's order issued on February 4, 1960 (56 F.T.C. 818), by deleting the provision that required the company to give the Commission 90 days' notice of any acquisition of a salt producer or distributor.

ORDER MODIFYING FINAL ORDER

On February 4, 1960, the Federal Trade Commission, pursuant to Section 7 of the Clayton Act, issued the Order in this case against Diamond Crystal Salt Company. The Commission has determined that the public interest would be served by deleting the provision of that Order that requires Diamond Crystal to give the Commission 90 days' notice of any acquisition of a salt producer or distributor. Respondent has no objection to this modification.

Accordingly,

It is ordered, That this matter be, and it hereby is, reopened and that the Order in Docket No. 7323 be modified so that the reporting requirement contained in Paragraph 5 terminates on the date of service of this order.

IN THE MATTER OF

CYNEX MANUFACTURING CORPORATION

CONSENT ORDER, ETC., IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket C-3139. Complaint, Aug. 6, 1984—Decision, Aug. 6, 1984

This Consent Order requires a Hillside, N.J. manufacturer and seller of a power factor controller (a device claimed to reduce the amount of electricity used by any motorized electrical home appliance or tool), among other things, to cease making any energy-related claim for its product unless the claim is based on competent and reliable substantiation. The order also bars respondent from making energy-related claims using the term "up to" or words of similar import, unless a significant number of consumers can achieve the maximum levels of savings or performance claimed; and where consumers cannot reasonably foresee the major factors or conditions affecting the maximum levels of savings or performance, respondent is required to clearly and prominently disclose the class of consumers who can achieve those levels. The firm is further prohibited from misrepresenting the purpose, content or conclusions of any test or study; and required to retain records substantiating claims for a period of three years.

Appearances

For the Commission: *Brinley H. Williams* and *Mitchell Paul.*

For the respondent: *Maurice H. Bitner,* Parsippany, N.J.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, as amended, and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that Cynex Manufacturing Corporation, hereinafter referred to as respondent, has violated the provisions of said Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

PARAGRAPH 1. Respondent is a corporation organized, existing and doing business under and by virtue of the laws of the State of New Jersey, with its office and principal place of business located at 28 Sager Place, Hillside, New Jersey.

PAR. 2. Respondent is now, and at all times relevant to this complaint has been, engaged in the manufacture and sale to the public of a device known as a power factor controller which is sold by respondent under the name "Watt Wizard Model PFC 1000".

PAR. 3. In the course and conduct of its business, respondent has caused its power factor controller, when sold, to be shipped from its place of business in New Jersey to its distributors, retailers and individual customers in various States of the United States. Respondent's manufacture, sale and distribution of its power factor controller constitutes maintenance of a substantial course of trade in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act.

PAR. 4. Respondent at all times mentioned herein has been and now is in competition with individuals, firms and corporations engaged in the sale of power factor controllers and other products.

PAR. 5. In the course and conduct of its business, and for the purpose of promoting the sale and distribution of its power factor controller, respondent has disseminated and caused the dissemination of advertising for its power factor controller in magazines, newspapers and catalogs distributed by mail and across state lines and in radio and television broadcasts transmitted by stations located in various States of the United States and the District of Columbia having sufficient power to carry such broadcasts across state lines. In addition, respondent has distributed by mail or other means, product brochures and other sales literature directly to consumers or to dealers for display or distribution to consumers prior to or at the time of sale.

PAR. 6. Typical of said advertisements and promotional materials, disseminated as previously described, but not necessarily inclusive thereof, are the advertisements and promotional materials attached hereto as Exhibits A, B, C, D, E, F, and G. An example of the statements contained in said advertisements is "Save up to 60% of the cost of running your motorized home & shop appliances" (Exhibit B).

PAR. 7. Through the use of the advertisements and promotional materials referred to in Paragraph Six and others not specifically set forth herein respondent has represented, and now represents, directly or by implication, that:

Use of the Watt Wizard Model PFC 1000 power factor controller will save an appreciable number of consumers 60 percent or close to 60 percent of the electricity used by and cost of operating any motorized electrical home appliance or tool under circumstances reasonably foreseen by consumers.

PAR. 8. In truth and in fact, contrary to respondent's representation set forth in Paragraph Seven:

(a) Few, if any, consumers, using Watt Wizard Model PFC 1000, will save 60 percent or close to 60 percent of the electricity used by and the cost of operating any motorized electrical home appliance or tool under reasonably foreseen circumstances.

(b) The Watt Wizard Model PFC 1000 power factor controller can only be used with appliances having electric alternating current motors, and therefore it cannot save electricity or reduce the cost of operating motorized electrical home appliances or tools powered by universal or brush motors.

Therefore, said representation is false, misleading and deceptive.

PAR. 9. In Exhibits A, B, C, D, E, F, G, and other advertisements and promotional materials substantially similar thereto, respondent has represented, directly or by implication, that at the time of the initial and each subsequent dissemination of the representation set forth in Paragraph Seven, it possessed and relied upon a reasonable basis for that representation.

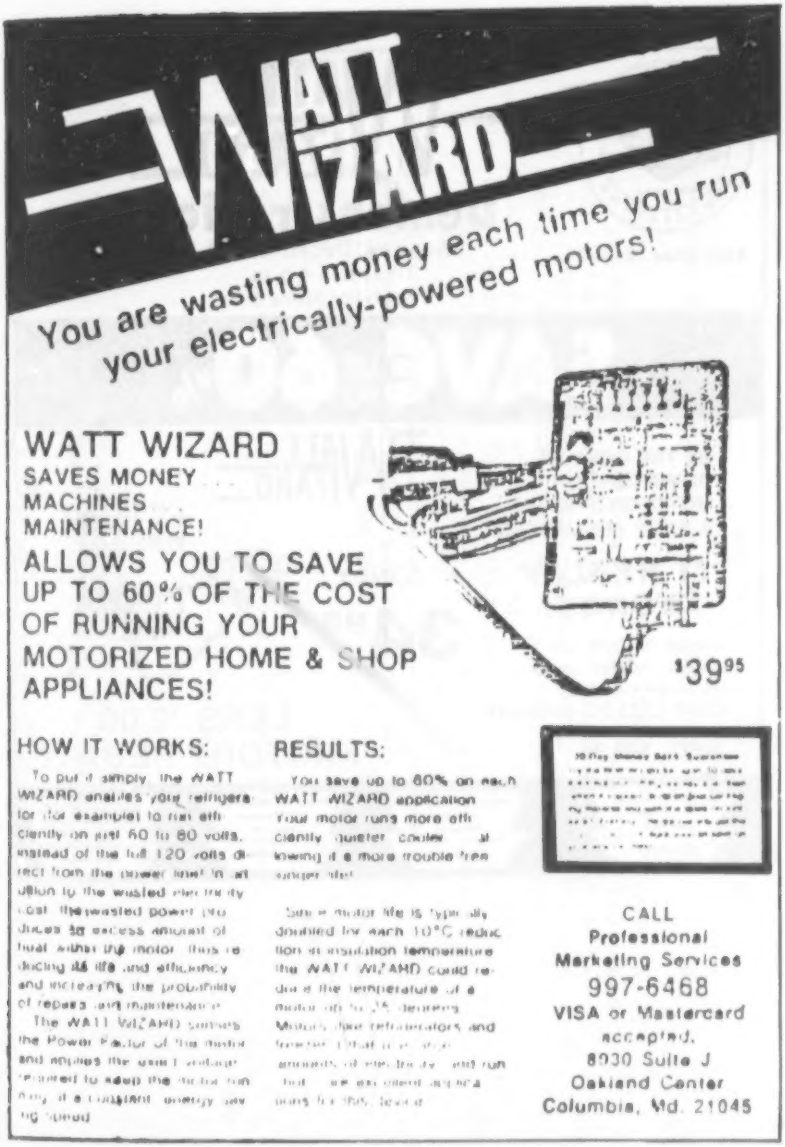
PAR. 10. In truth and in fact, respondent did not possess and rely upon a reasonable basis for the representation set forth in Paragraph Seven, because, *inter alia*, respondent's test protocols and calculations were not designed or conducted to assess product performance under circumstances reasonably foreseen by consumers in operating motorized electrical home appliances or tools. Therefore, the advertisements and promotional materials containing the representation set forth in Paragraph Seven were and are false, misleading and deceptive.

PAR. 11. The use by respondent of the aforesaid false, misleading and deceptive representations and the placement in the hands of its distributors and retailers of the means and instrumentalities by and through which others may have used the aforesaid false, misleading and deceptive representations have had the capacity and tendency to mislead consumers into the erroneous and mistaken belief that said representations were and are true and complete, and into the purchase of respondent's power factor controller by reason of said erroneous and mistaken belief.

PAR. 12. The acts and practices of respondent as herein alleged are all to the prejudice and injury of the public and of respondent's competitors, and constitute unfair methods of competition and unfair and deceptive acts or practices in or affecting commerce, in violation of Section 5(a) of the Federal Trade Commission Act.

Commissioners Pertschuk and Bailey voted in the negative.

EXHIBIT A


WATT WIZARD
You are wasting money each time you run your electrically-powered motors!

WATT WIZARD
SAVES MONEY ...
MACHINES ...
MAINTENANCE!

ALLOWS YOU TO SAVE UP TO 60% OF THE COST OF RUNNING YOUR MOTORIZED HOME & SHOP APPLIANCES!

$39.95

HOW IT WORKS:

To put it simply, the WATT WIZARD enables your refrigerator (for example) to run efficiently on just 60 to 80 volts, instead of the full 120 volts direct from the power line. In addition to the wasted electricity cost, the wasted power produces an excess amount of heat within the motor, thus reducing its life and efficiency and increasing the probability of repairs and maintenance.

The WATT WIZARD senses the Power Factor of the motor and applies the exact voltage required to keep the motor running at a constant, energy saving speed.

RESULTS:

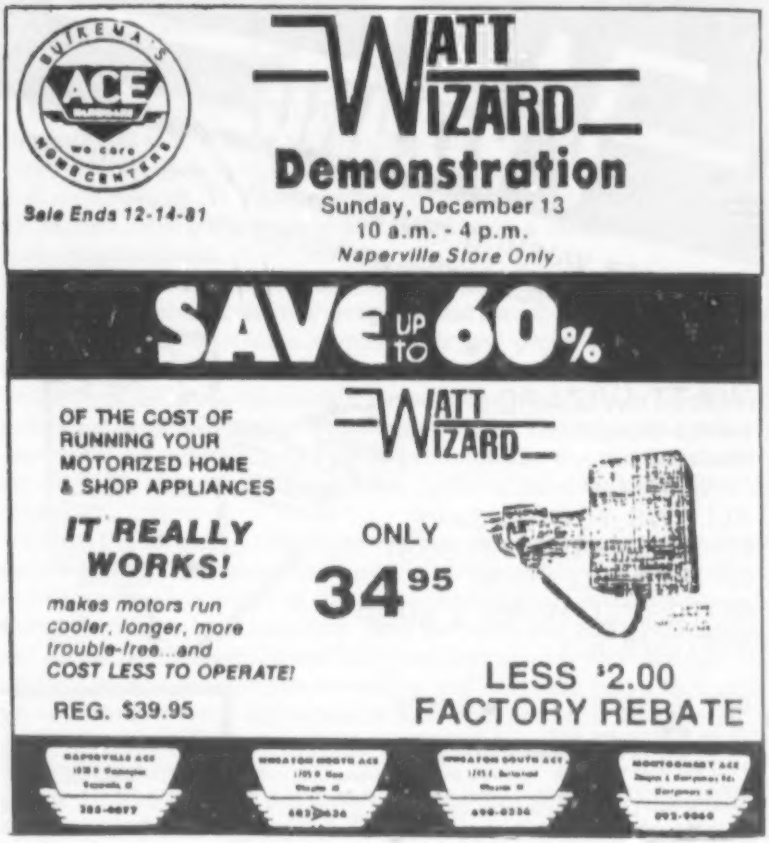
You save up to 60% on each WATT WIZARD application. Your motor runs more efficiently, quieter, cooler ... allowing it a more trouble free, longer life.

Since motor life is typically doubled for each 10°C reduction in insulation temperature, the WATT WIZARD could reduce the temperature of a motor up to 25 degrees. Motors (like refrigerators and freezers) that use large amounts of electricity and run [illegible] are excellent applications for this device.

10 Day Money Back Guarantee
[illegible]

CALL
Professional
Marketing Services
997-6468
VISA or Mastercard
accepted.
8030 Suite J
Oakland Center
Columbia, Md. 21045

EXHIBIT B



BUIKEMA'S ACE HOMECENTERS we care

Sale Ends 12-14-81

WATT WIZARD

Demonstration

Sunday, December 13

10 a.m. - 4 p.m.

Naperville Store Only

SAVE UP TO 60%

OF THE COST OF RUNNING YOUR MOTORIZED HOME & SHOP APPLIANCES

WATT WIZARD

IT REALLY WORKS!

makes motors run cooler, longer, more trouble-free...and COST LESS TO OPERATE!

ONLY

34^{95}

REG. $39.95

LESS $2.00 FACTORY REBATE

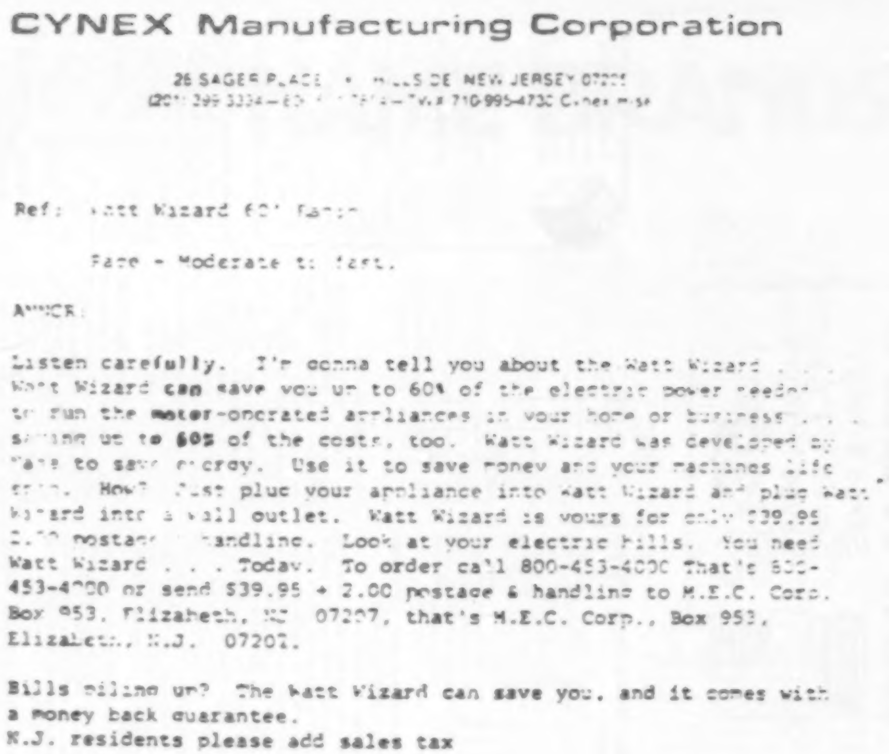
NAPERVILLE ACE

WHEATON NORTH ACE

WHEATON SOUTH ACE

MONTGOMERY ACE

EXHIBIT C



CYNEX Manufacturing Corporation

26 SAGER PLACE • HILLSIDE NEW JERSEY 07205
(201) 399-3334 — [illegible] — TWX 710-995-4730 Cynex Hise

Ref: Watt Wizard 60" Radio

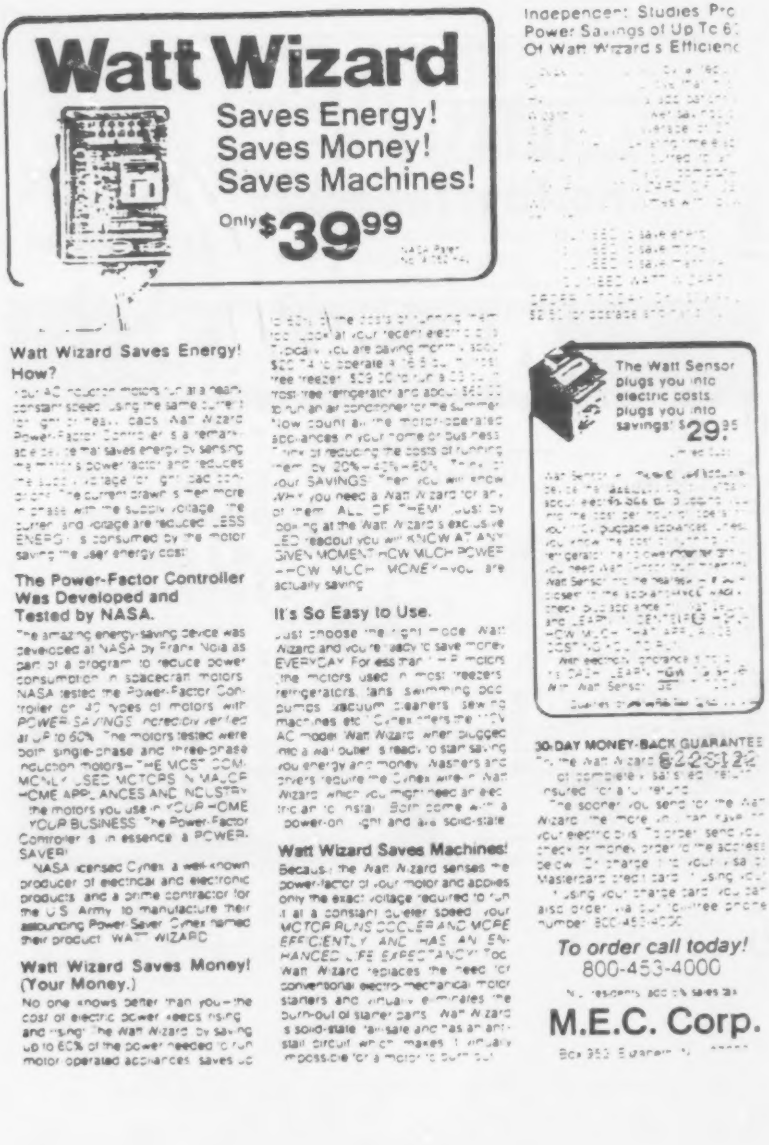
Pace - Moderate to fast.

ANNCR:

Listen carefully. I'm gonna tell you about the Watt Wizard . . . Watt Wizard can save you up to 60% of the electric power needed to run the motor-operated appliances in your home or business . . . saving up to 60% of the costs, too. Watt Wizard was developed by NASA to save energy. Use it to save money and your machines life span. How? Just plug your appliance into Watt Wizard and plug Watt Wizard into a wall outlet. Watt Wizard is yours for only $39.95 2.00 postage & handling. Look at your electric bills. You need Watt Wizard . . . Today. To order call 800-453-4000 That's 800-453-4000 or send $39.95 + 2.00 postage & handling to M.E.C. Corp. Box 953, Elizabeth, NJ 07207, that's M.E.C. Corp., Box 953, Elizabeth, N.J. 07207.

Bills piling up? The Watt Wizard can save you, and it comes with a money back guarantee.
N.J. residents please add sales tax

EXHIBIT D



Watt Wizard

Saves Energy!
Saves Money!
Saves Machines!

Only $39.99

NASA Patent
No. 4,052,648

Watt Wizard Saves Energy! How?

Your AC induction motors run at a nearly constant speed using the same current for light or heavy loads. Watt Wizard Power-Factor Controller is a remarkable device that saves energy by sensing the motor's power factor and reduces the supply voltage for light load conditions. The current drawn is then more in phase with the supply voltage. The current and voltage are reduced. LESS ENERGY is consumed by the motor saving the user energy cost!

The Power-Factor Controller Was Developed and Tested by NASA.

The amazing energy-saving device was developed at NASA by Frank Nola as part of a program to reduce power consumption in spacecraft motors. NASA tested the Power-Factor Controller on 40 types of motors with POWER SAVINGS incredibly verified at UP to 60%. The motors tested were both single-phase and three-phase induction motors—THE MOST COMMONLY USED MOTORS IN MAJOR HOME APPLIANCES AND INDUSTRY ... the motors you use in YOUR HOME ... YOUR BUSINESS. The Power-Factor Controller is in essence a POWER-SAVER!

NASA licensed Cynex, a well-known producer of electrical and electronic products and a prime contractor for the U.S. Army, to manufacture their astounding Power Saver. Cynex named their product WATT WIZARD.

Watt Wizard Saves Money! (Your Money.)

No one knows better than you—the cost of electric power keeps rising and rising! The *Watt Wizard*, by saving up to 60% of the power needed to run motor operated appliances, saves up to 60% of the costs of running them. Look at your recent electric bill. Typically you are paying monthly about $20.74 to operate a 16.5 cu. ft. frost free freezer, $29.00 to run a 23 cu. ft. frost-free refrigerator and about $60.00 to run an air conditioner for the summer. Now count all the motor-operated appliances in your home or business. Think of reducing the costs of running them by 20%—40%—60%. Think of your SAVINGS! Then you will know WHY you need a *Watt Wizard* for any of them ... ALL OF THEM! Just by looking at the Watt Wizard's exclusive LED readout you will KNOW AT ANY GIVEN MOMENT HOW MUCH POWER—HOW MUCH MONEY—you are actually saving.

It's So Easy to Use.

Just choose the right model Watt Wizard and you're ready to save money EVERYDAY. For less than 1 HP motors (the motors used in most freezers, refrigerators, fans, swimming pool pumps, vacuum cleaners, sewing machines, etc.) Cynex offers the 110V AC model Watt Wizard which, when plugged into a wall outlet, is ready to start saving you energy and money. Washers and dryers require the Cynex wire-in Watt Wizard which you might need an electrician to install. Both come with a power-on light and are solid-state.

Watt Wizard Saves Machines!

Because the *Watt Wizard* senses the power-factor of your motor and applies only the exact voltage required to run it at a constant quieter speed, your *MOTOR RUNS COOLER AND MORE EFFICIENTLY AND HAS AN ENHANCED LIFE EXPECTANCY!* Too, *Watt Wizard* replaces the need for conventional electro-mechanical motor starters and virtually eliminates the burn-out of starter parts. *Watt Wizard* is solid-state, fail-safe and has an anti-stall circuit which makes it virtually impossible for a motor to burn out.

Independent Studies Pro
Power Savings of Up To 6
Of Watt Wizard's Efficienc

[illegible]

... to save energy
... to save money
... to save machines
... NEED WATT WIZARD
ORDER ... TODAY ...
$2.50 for postage and handling.

The Watt Sensor plugs you into electric costs, plugs you into savings! $29.95

Limited Supply

Watt Sensor ... [illegible]

Quantities ... [illegible]

30-DAY MONEY-BACK GUARANTEE

Try the Watt Wizard 6226122 ... If not completely satisfied, return ... insured for a full refund.

The sooner you send for the Watt Wizard, the more you can save on your electric bills. To order, send your check or money order to the address below. Or charge it to your Visa or Mastercard credit card. If using your charge card, you can also order via our toll-free phone number 800-453-4000.

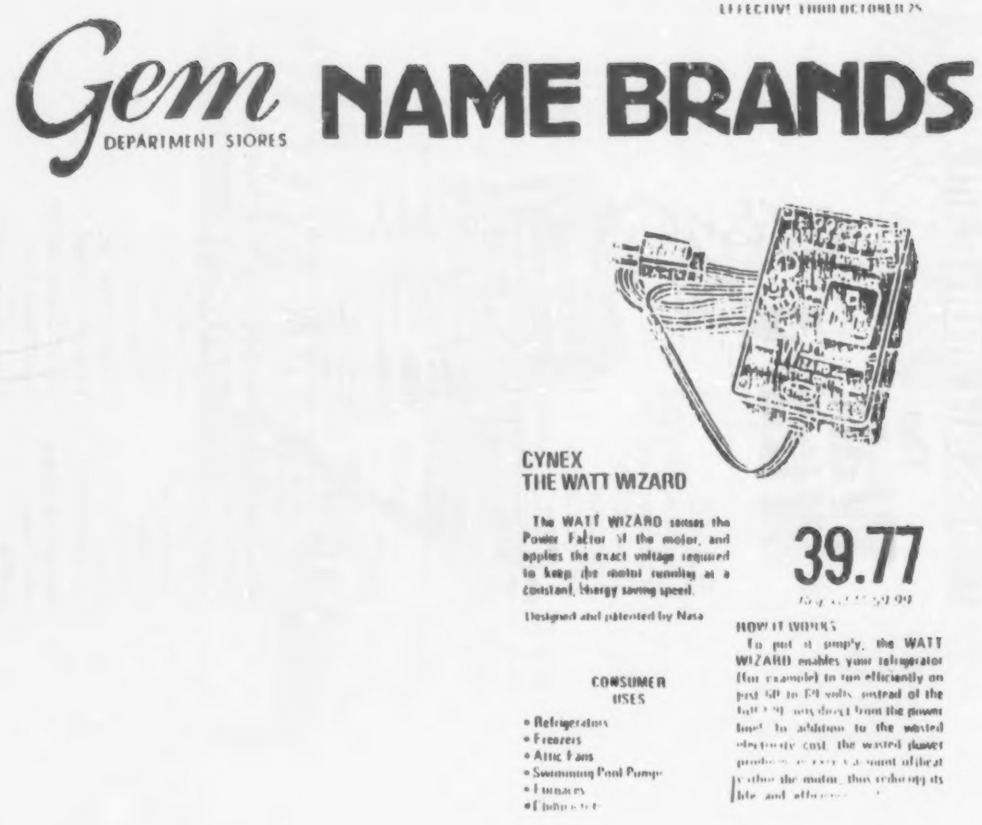
To order call today!
800-453-4000

N.J. residents add 5% sales tax

M.E.C. Corp.

Box 353 Elizabeth, N.J. [illegible]

EXHIBIT E



EFFECTIVE THRU OCTOBER 28

Gem DEPARTMENT STORES **NAME BRANDS**

CYNEX
THE WATT WIZARD

The WATT WIZARD senses the Power Factor of the motor, and applies the exact voltage required to keep the motor running at a constant, energy saving speed.

Designed and patented by Nasa

39.77

Reg. [illegible]

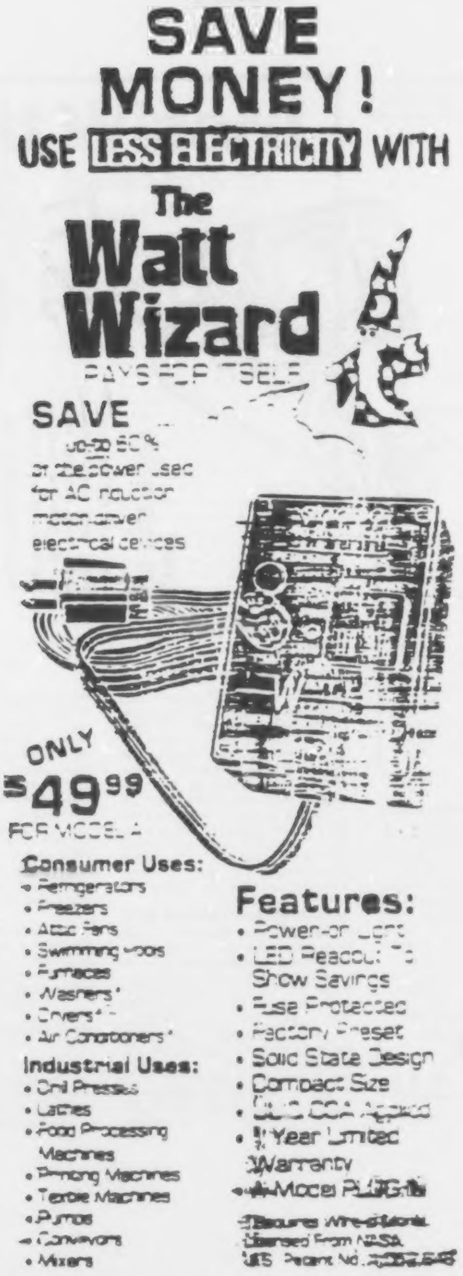
CONSUMER USES

- Refrigerators
- Freezers
- Attic Fans
- Swimming Pool Pumps
- Furnaces
- [illegible]

HOW IT WORKS

To put it simply, the WATT WIZARD enables your refrigerator (for example) to run efficiently on just 60 to 80 volts, instead of the full 120 volts direct from the power line! In addition to the wasted electricity cost, the wasted power produces an excess amount of heat within the motor, thus reducing its life and efficiency [illegible]

EXHIBIT F



SAVE MONEY!

USE **LESS ELECTRICITY** WITH

The Watt Wizard

PAYS FOR ITSELF

SAVE up to 60% of the power used for AC induction motor-driven electrical devices

ONLY $49.99 FOR MODEL A

Consumer Uses:

- Refrigerators
- Freezers
- Attic Fans
- Swimming Pools
- Furnaces
- Washers*
- Dryers**
- Air Conditioners*

Industrial Uses:

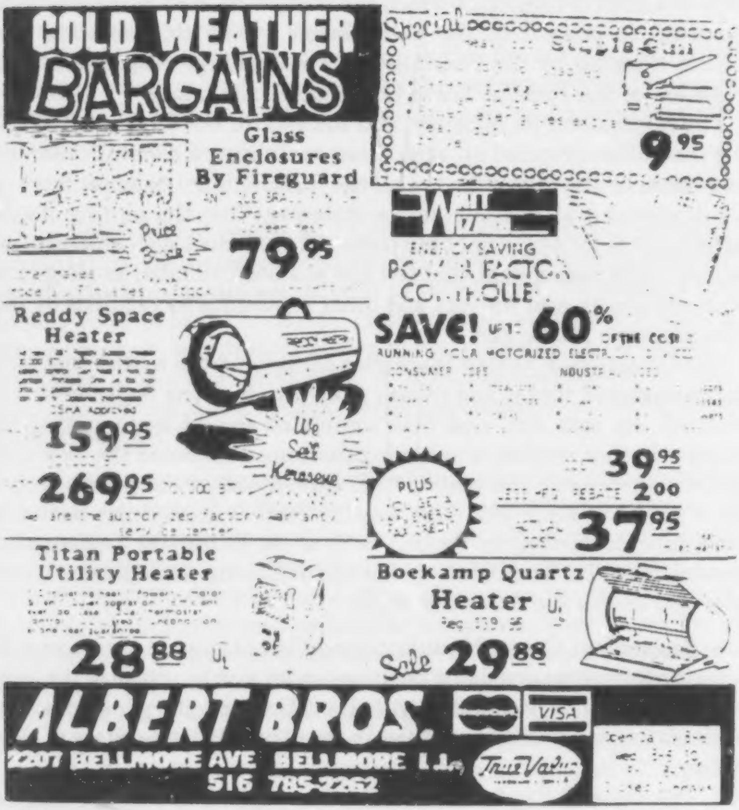
- Drill Presses
- Lathes
- Food Processing Machines
- Printing Machines
- Textile Machines
- Pumps
- Conveyors
- Mixers

Features:

- Power-on Light
- LED Readout To Show Savings
- Fuse Protected
- Factory Preset
- Solid State Design
- Compact Size
- UL/C CSA Applied
- 1 Year Limited Warranty
- Model PL/G-1

*Requires Wire-in Models.
Licensed From NASA
U.S. Patent No. [illegible]

EXHIBIT G



COLD WEATHER BARGAINS

Glass Enclosures By Fireguard

Price Break

79.95

Special

9.95

ENERGY SAVING POWER FACTOR CONTROLLER

SAVE! UP TO 60% OF THE COST OF RUNNING YOUR MOTORIZED ELECTRICAL DEVICES

CONSUMER USES

INDUSTRIAL USES

39.95

LESS MFG. REBATE 2.00

ACTUAL COST 37.95

PLUS

Reddy Space Heater

OSHA Approved

159.95

269.95

We Sell Kerosene

We are the authorized factory warranty service center

Titan Portable Utility Heater

28.88

Boekamp Quartz Heater

Sale 29.88

ALBERT BROS.

2207 BELLMORE AVE BELLMORE L.I.

516 785-2262

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of complaint which the Bureau of Consumer Protection proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Federal Trade Commission Act; and

The respondent, its attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondent has violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent Cynex Manufacturing Corporation is a corporation organized, existing and doing business under and by virtue of the laws of the State of New Jersey, with its office and principal place of business located at 28 Sager Place, in the City of Hillside, State of New Jersey.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

Definitions

For purposes of this order, the following definitions shall apply:

Energy-related claim means any general or specific, oral or written representation that, directly or by implication, describes or refers to energy savings, efficiency or conservation, electricity savings, or electricity cost savings.

A *competent and reliable test* means any scientific, engineering, or other analytical report or study prepared by one or more persons with skill and expert knowledge in the field to which the material pertains and based on testing, evaluation, and analytical procedures that ensure accurate and reliable results.

A *power factor controller* means any device for use with motorized home appliances or tools that reduces the voltage applied to electric alternating current motors by sensing the phase angle between motor voltage and current.

PART I

It is ordered, That respondent Cynex Manufacturing Corporation, a corporation, its successors and assigns, and its officers, agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, offering for sale, sale or distribution of any power factor controller or any other product or service, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

(1) Making any energy-related claim for any power factor controller unless, at the time that the claim is made, respondent possesses and relies upon a reasonable basis consisting of a competent and reliable test or other objective material which substantiates the claim.

(2) Making any energy-related claim which uses the phrase "up to" or words of similar import unless the maximum level of savings or performance can be achieved by an appreciable number of consumers; and, further, in any instances where consumers could not reasonably foresee the major factors or conditions affecting the maximum level of savings or performance, cease and desist from failing to disclose clearly and prominently the class of consumers who can achieve the maximum level of savings or performance.

(3) Making any claim concerning the performance capabilities of any power factor controller unless, at the time that the claim is made, respondent possesses and relies upon a reasonable basis consisting of a competent and reliable test or other objective material which substantiates the claim.

(4) Misrepresenting in any manner, directly or by implication, the purpose, content, or conclusion of any test or study upon which respondent relies as substantiation for any energy-related claim or performance claim, or making any statement or representation which is inconsistent with the results or conclusions of any such test or study.

PART II

It is further ordered, That respondent, its successors and assigns, and its officers, agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, offering for sale, sale or distribution of any power factor controller, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, shall maintain written records:

1. Of all materials relied upon in making any claim or representation covered by this order;
2. Of all test reports, studies, surveys or demonstrations in its possession that contradict, qualify, or call into question the basis upon which respondent relied at the time of the initial dissemination and each continuing or successive dissemination of any claim or representation covered by this order.

Such records shall be retained by respondent for a period of three years from the date respondent's advertisements, sales materials, promotional materials or post purchase materials making such claim or representation were last disseminated. Such records shall be made available to the Commission staff for inspection upon reasonable notice.

PART III

It is further ordered, That respondent shall forthwith distribute a copy of this order to each of its operating divisions and to each of its officers, agents, representatives or employees engaged in the preparation and placement of advertisements or other sales materials, and to each of its distributors, dealers and any other person engaged in the wholesale or retail sale of any power factor controller manufactured by or for respondent.

PART IV

It is further ordered, That respondent notify the Commission at least thirty (30) days prior to the effective date of any proposed change in the corporate respondent such as dissolution, assignment or sale, resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries, or any other change in the corporation which may affect compliance obligations arising out of this order.

PART V

It is further ordered, That respondent shall, within sixty (60) days after this order becomes final, file with the Commission a report in writing, setting forth in detail the manner and form in which it has complied with the order.

Commissioners Pertschuk and Bailey voted in the negative.

IN THE MATTER OF

SOVEREIGN CHEMICAL & PETROLEUM PRODUCTS, INC.

CONSENT ORDER, ETC., IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket C-3140. Complaint, Aug. 8, 1984—Decision, Aug. 8, 1984

This consent order requires a Chicago, Ill. manufacturer and seller of automotive products, among other things, to cease representing that any automatic transmission fluid or motor oil possesses certain performance or quality characteristics, including any claim that a motor oil has an American Petroleum Institute (API) service classification or a Society of Automotive Engineers (SAE) viscosity, unless such claims can be substantied by competent and reliable evidence. Respondent must retain representative samples of motor oil and automatic transmission fluid from its production batches and filling runs, documents its sampling method, and pay for an independent laboratory to test these and other samples obtained in the marketplace. Respondent must also maintain records to substantiate claims covered by the order and distribute a copy of the order to all personnel with responsibility for advertising, quality control or corporate policy.

Appearances

For the Commission: *James K. Leonard.*

For the respondent: *Ira Berman, Zissu, Berman, Halper, Barron & Gumbinger,* Chicago, Ill. and *Gary B. Homsey,* Oklahoma City, Okl.

COMPLAINT

The Federal Trade Commission, having reason to believe that Sovereign Chemical & Petroleum Products, Inc., hereinafter referred to as respondent, has violated Section 5 of the Federal Trade Commission Act and that an action is in the public interest, issues this complaint and alleges:

PARAGRAPH 1. Respondent Sovereign Chemical & Petroleum Products, Inc., is a Delaware corporation with its office and principal place of business located at 6801 West 66th Place, Chicago, Il. Until August 18, 1982, respondent was known as Sovereign Oil Company, Inc. All of the respondent's business is done through its four wholly-owned subsidiaries: Future Chemical & Oil Corporation (New York), Sovereign Oil Company (Illinois), Sovereign Oil Company of Pennsylvania, Inc., and Sovereign Oil of Florida, Inc.

PAR. 2. Respondent is, and has been, engaged in the manufacture and sale of substantial quantities of motor oils, automatic transmission fluids and other automotive products. Respondent packages its products under its own brand names, including "Monarch" and "Route 55," and under the brand names of independent merchandisers.

PAR. 3. In the course and conduct of its business, respondent causes its products to be sent to purchasers throughout the United States. Respondent prepares promotional and labeling materials for its products and disseminates these materials throughout the United States. Respondent maintains, and at all times relevant herein has maintained, a substantial course of trade in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act.

PART I

Alleging violations of Section 5 of the Federal Trade Commission Act, the allegations of Paragraphs One through Three are incorporated by reference.

PAR. 4. In the course and conduct of its business, and in order to induce the sale of its motor oils, respondent has made statements on the labels and tops of its containers of motor oil. Typical of these statements are the following:

1. SAE 10W-40
2. For API Service SF SE SD

PAR. 5. Through the use of these and other similar statements, respondent has represented, directly or by implication, that its motor oils meet standards established by the Society of Automotive Engineers (SAE) and by the American Petroleum Institute (API) and that its motor oils therefore have a certain SAE viscosity and API service classification.

PAR. 6. In truth and in fact, the actual SAE viscosity of respondent's motor oil has frequently been different from the SAE viscosity (for example, 10W-40) marked on the container, and the actual API service classification has frequently been different from the API service classification (for example, SF SE SD) marked on the container. Therefore, the statements described in Paragraph Four and the representations described in Paragraph Five have been and are false and misleading.

PAR. 7. Respondent's false and misleading statements and representations have had the tendency to induce consumers to buy and use motor oils not suited for the purpose of protecting automobile engines from undue wear. This has caused and causes substantial injury to consumers which they could not have reasonably avoided.

PAR. 8. The statements and representations described in Paragraphs Four and Five, respectively, having had the capacity and tendency to mislead the public, and having been to the prejudice and injury of the public, therefore were and are unfair and deceptive acts or practices in violation of Section 5 of the Federal Trade Commission Act.

PART II

Alleging violations of Section 5 of the Federal Trade Commission Act, the allegations of Paragraphs One through Five are incorporated by reference:

PAR. 9. Through the use of the statements alleged in Paragraph Four, respondent has represented, directly or by implication, that it possessed and relied upon a reasonable basis for making the representations set forth in Paragraph Five at the times they were made. In truth and in fact, respondent did not then possess and rely upon a reasonable basis for making such representations. Therefore, respondent's representations have been and are false and misleading.

PAR. 10. The representations alleged in Paragraph Five, having had the capacity and tendency both to mislead the public to think that respondent had a reasonable basis for those representations and to induce the sale of respondent's motor oils, and having been to the prejudice and injury of the public, therefore were and are unfair and deceptive acts or practices in violation of Section 5 of the Federal Trade Commission Act.

The acts and practices of respondent alleged in this complaint are continuing and will continue in the absence of the relief requested herein.

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of respondent Sovereign Chemical & Petroleum Products, Inc., and respondent having been furnished thereafter with a copy of a draft of complaint which the Chicago Regional Office proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Federal Trade Commission Act; and

Respondent, its attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that respondent has violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, and having duly considered the comments filed thereafter by interested persons pursuant to Section 2.34 of its Rules, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent Sovereign Chemical & Petroleum Products, Inc., is a corporation organized, existing and doing business under and by virtue of the laws of the State of Delaware, with its office and principal place of business located at 6801 West 66th Place, in the City of Chicago, State of Illinois.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of respondent, and the proceeding is in the public interest.

ORDER

I

It is ordered, That for purposes of this Order, the following definition shall apply:

Sovereign shall mean respondent Sovereign Chemical & Petroleum Products, Inc., a corporation, and its subsidiaries; their successors and assigns; and their officers, agents, representatives and employees.

II

It is further ordered, That Sovereign, directly or through any corporation, subsidiary, division or other device, in connection with the production, advertising, offering for sale, sale or distribution of any motor oil or automatic transmission fluid in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from representing, directly or by implication:

A. That any motor oil has any American Petroleum Institute (API) service classification; or

B. That any motor oil has any Society of Automotive Engineers (SAE) viscosity; or

C. That any automatic transmission fluid meets any specification set by General Motors Corporation, Ford Motor Company or any other company; or

D. That any motor oil or automatic transmission fluid possesses any other performance or quality characteristic;

unless such representation is true and unless, at the time of making such representation, Sovereign possesses and relies upon a reasonable basis consisting of competent and reliable evidence which substantiates the representation.

III

It is further ordered, That Sovereign shall draw a representative sample from each production batch or run, and from each filling run, of motor oil or automatic transmission fluid, shall document the method or methods used to draw such samples, and shall for at least one year retain a properly marked portion of each such sample and that for a period of three years after the date of service of this Order Sovereign shall, at the option of the Commission, cause to be tested (as described below) by a competent and independent laboratory, at Sovereign's expense, up to 50 (fifty) samples of motor oil and/or automatic transmission fluid, the samples either being such retained samples or being samples sold by Sovereign, and shall submit to the Commission copies of the results of such tests:

A. Motor oil samples tested pursuant to this Part shall be subjected to the then current version of the following American Society for Testing and Materials (ASTM) tests and other tests or any succeeding tests that have the same force and effect:

1. Kinematic viscosity at 100 degrees C. (ASTM D445);
2. Kinematic viscosity at 40 degrees C. (ASTM D445) (test required only for single-grade oils);
3. Low-temperature viscosity (ASTM D2602) (test required only for multigrade oils);
4. Viscosity index (ASTM D2770) (test required only for single-grade oils);
5. Nitrogen (ASTM D3228 or chemiluminescence);
6. Color (ASTM D1500);
7. Total Base Number (ASTM D664); and

8. Elemental analysis showing parts per million of calcium, magnesium, phosphorus, and zinc (emission spectrometry or other generally accepted method).

B. Automatic transmission fluid samples tested pursuant to this Part shall be subjected to the then current version of the following tests or any succeeding tests that have the same force and effect:

1. Kinematic viscosity at 100 degrees C. (ASTM D445);
2. Flash point (ASTM D92);
3. Brookfield viscosity at -40 degrees C. (ASTM D2983);
4. Copper strip corrosion (ASTM D130) (for automatic transmission fluids represented to meet a General Motors specification, three hours at 150 degrees C.; for automatic transmission fluids represented to meet any other specification, three hours at 100 degrees C.); and
5. Antifoam test (for automatic transmission fluids represented to meet a General Motors specification, the procedure described in General Motors document RLSP73-2, Second Edition, July 1978, or any succeeding document with the same force and effect; for automatic transmission fluids represented to meet any other specification, ASTM D892).

IV

It is further ordered, That for any motor oil or automatic transmission fluid sold by Sovereign for three years after the date of service of this Order, Sovereign shall maintain records which substantiate the representations listed in Part II of this Order, shall retain such records for three years from the last date on which the representation to which it pertains was made and upon reasonable notice shall make such records available to the Commission for inspection and copying. For motor oils and automatic transmission fluids produced or packaged by Sovereign, such records shall include blend formulas; specifications for motor oils and automatic transmission fluids; formulas and specifications supplied to Sovereign by additive companies, and documents describing the physical and chemical characteristics of additives purchased by Sovereign; records describing Sovereign's purchases and inventories of base stocks and additives; records showing for each production batch or run the production date, the gallonage of each ingredient used in production, the date of transfer to a holding or storage tank, the holding or storage tank(s) used, and the results of quality control tests run; records showing for each holding or storage tank the date of each filling run from that tank and the dates on which that tank is emptied; and records showing for each filling run the size and number of containers filled, the results of quality control tests run, and, if known at the time of the filling run, the shipping destination and intended customer.

V

It is further ordered, That respondent shall forthwith distribute a copy of this Order to each of its subsidiaries and divisions and to all agents, representatives or employees having advertising, quality control or corporate policy responsibilities with respect to the subject matter of this Order.

VI

It is further ordered, That respondent, its successors and assigns notify the Commission at least thirty (30) days prior to any proposed change to itself, such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change which may affect compliance obligations arising out of this Order.

VII

It is further ordered, That respondent, its successors and assigns shall, within sixty (60) days after the date of service of this Order, file with the Commission a report, in writing, setting forth in detail the manner and form in which it has complied with this Order.

In the Matter of

AVCO FINANCIAL SERVICES, INC.

CONSENT ORDER IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket C-3141. Complaint, Aug. 9, 1984—Decision, Aug. 9, 1984

This consent order requires a Newport Beach, Ca. finance company to cease, in connection with the collection of debts, using obscenities in conversations with debtors and third parties; threatening to use physical force or violence; improperly contacting or communicating with debtors, their friends, relatives and employers; or engaging in any conduct that would harass, abuse or oppress a debtor or third party. The order prohibits the company from contacting consumers known to be represented by an attorney or who request in writing that the company cease communications. The order further requires respondent to maintain a toll-free customer service telephone number; include in certain notices, a prescribed statement informing the recipient of his/her rights under federal law and of the availability of complaint resolution procedures; resolve complaints within 90 days; maintain a plan with explicit policies and procedures for lawful debt collection practices; and impose disciplinary sanctions for violations of this plan.

Appearances

For the Commission: *Christopher Schwartz.*

For the respondent: *Herbert Smith,* Newport Beach, Ca.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that Avco Financial Services, Inc., a corporation, hereinafter sometimes referred to as respondent or Avco, has violated the provisions of said Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

PARAGRAPH 1. For purposes of this complaint the following definitions shall apply:

A. *Consumer loan* means a cash advance by Avco, which is received by a consumer, for which the payment of a *finance charge* within the meaning of the Truth in Lending Act, 15 U.S.C. 1601, and Regulation Z, 16 C.F.R. 226 (1980), is or may be required, and which is used primarily for personal, family or household purposes.

B. *Debt* means any obligation or alleged obligation of a consumer to pay money to Avco, in which the money, property, or services which are the subject of the transaction which gave rise to the obligation are primarily for personal, family or household purposes, whether or not such obligation has been reduced to judgment.

C. *Debtor* or *Consumer* means any natural person obligated or alleged by Avco to be obligated to pay any debt, including any cosigner.

D. *Delinquent* means the state at which a debt is due and unpaid at the time fixed by contract.

E. *Subsidiary* means any domestic corporation or entity, fifty (50) percent or more of the outstanding voting shares of which are owned directly or indirectly by Avco.

F. *Third party* means any natural person or any entity not obligated to pay the debt which is the basis of the debt collection activity by Avco.

PAR. 2. Respondent, Avco Financial Services, Inc., is a corporation organized, existing and doing business under and by virtue of the laws of the State of Delaware, with its office and principal place of business located at 620 Newport Center Drive, Newport Beach, California. Respondent's policy and procedures are developed in and disseminated from Avco's principal place of business. Such policies and procedures govern respondent's operations throughout the United States. Avco now exercises and for some time in the past has exercised domination and control over the acts and practices of its wholly-owned subsidiaries and the acts and practices of each Avco branch office.

PAR. 3. Avco conducts and has conducted its business in all States of the United States (except Arkansas and Alaska) and in the United States Commonwealth of Puerto Rico, directly and indirectly through approximately 165 wholly-owned domestic subsidiaries. Avco operates approximately 620 branch offices in the United States. Therefore, respondent maintains and has maintained a substantial course of business which is in or affects commerce, as defined in the Federal Trade Commission Act.

PAR. 4. Respondent is now and has for some time in the past been regularly engaged in the extension of consumer credit in various forms. Avco's business activities denominated herein as financial service operations include and have included issuance of consumer loans, including the refinancing of consumers' outstanding indebtedness. Avco's business activities denominated herein as sales finance operations include the acquisition and issuance of retail installment contracts. In the ordinary course and conduct of the aforesaid business, respondent, through its representatives, agents and employees, regularly engages and has engaged in the collection of debts arising from these transactions.

PAR. 5. In the course and conduct of its aforesaid business, and for the purpose of inducing payment on debts alleged by respondent to be delinquent, Avco, through its representatives, agents and employees, has engaged in, and in some instances continues to engage in the following acts and practices:

(a) Using obscene or profane language in conversations with debtors or third parties, or language or tone of voice the natural consequence of which is to harass or abuse such persons.

(b) Making repeated or continuous telephone calls to debtors or third parties with intent to harass or abuse persons at the called number.

(c) Contacting debtors or third parties by telephone or otherwise, at times or places which Avco knew or should have known would interfere with the debtors' or third parties' employment or would harass or abuse the debtors or third parties.

(d) Using or threatening the use of force or violence against a debtor's person or property.

PAR. 6. The use by respondent of the acts and practices described in Paragraph Five has had and now has the capacity and tendency to cause substantial injury to debtors or third parties who are contacted by Avco by, among other things, adversely affecting the debtor's reputation, interfering with the debtor's or third party's employment relations including, but not limited to, causing warnings by employers of possible discharge, impairing the debtor's relations with friends, relatives, neighbors, and co-workers, and inducing the payment of disputed debts. Therefore, the use by respondent of such acts and practices was and is unfair.

PAR. 7. In the course and conduct of its aforesaid business, and for the purpose of inducing payment on debts alleged to be delinquent, Avco, through its representatives, agents and employees, has communicated, and in some instances continues to communicate, the existence of a consumer's debt, directly or by implication, to third party employers, co-employees, friends, neighbors or relatives of the debtor, without the prior consent of the consumer or the permission of a court of competent jurisdiction, and before the entry of a judgment thereon.

PAR. 8. The acts and practices of respondent set forth in Paragraph Seven has had and now has the capacity and tendency to cause substantial injury to debtors or third parties who are contacted by Avco by, among other things, adversely affecting the debtor's reputation, interfering with the debtor's employment relations including, but not limited to, causing warnings by employers of possible discharge, impairing the debtor's relations with friends, relatives, neighbors, and co-workers, and inducing the payment of disputed debts. Therefore, the use by respondent of such facts and practices was and is unfair.

PAR. 9. In the course and conduct of its aforesaid business, and for the purpose of inducing payment on debts alleged by Avco to be delinquent, respondent, through its representatives, agents and employees, in conversations with debtors, by telephone or otherwise, utilized, and in some instances continue to utilize, fictitious identities including, but not limited to, attorneys, deputy sheriffs, police officers and other law enforcement officials.

PAR. 10. In truth and in fact, the said representatives, agents and employees of respondent were and are not the persons whom they purported to be as described in Paragraph Nine. Therefore, the representatives referred to in Paragraph Nine were and are false, misleading and deceptive.

PAR. 11. In the course and conduct of its aforesaid business, and for the purpose of inducing payment on debts alleged by Avco to be delinquent, respondent, through its representatives, agents, and employees has represented, and in some instances continues to represent to debtors, directly or by implication, orally or in writing that:

(a) Unless payment is received, respondent will institute or will cause to be instituted legal action against the debtor.

(b) Unless payment is received, respondent will seize or repossess, or will cause to be seized or repossessed, the property of the debtor.

PAR. 12. In truth and in fact, representations set forth in Paragraph Eleven were made, and in some instances continue to be made, where respondent did not intend and did not take the specified actions in the event of nonpayment. Therefore, such representations have been and are false, misleading and deceptive.

PAR. 13. The use by respondent of the false, misleading and deceptive representations set forth in Paragraphs Nine and Eleven has had and now has the capacity and tendency to mislead debtors into the belief that such representations are true, and to induce and coerce by subterfuge the payment of alleged delinquent debts by reason of such erroneous and mistaken belief.

PAR. 14. In the course and conduct of its aforesaid business, and for the purpose of acquiring information regarding the whereabouts of the debtor, respondent, through its representatives, agents and employees, in conversations with third parties by telephone or otherwise, has utilized, and in some instances continues to utilize, various fictitious identities including, but not limited to, insurance investigators, persons with money due to the debtor, friends and relatives of the debtor, and law enforcement officials.

PAR. 15. In truth and in fact, the said representatives, agents or employees of respondent were and are not the persons whom they purported to be as described in Paragraph Fourteen. Therefore, the representations referred to in Paragraph Fourteen were and are false, misleading and deceptive.

PAR. 16. The use by respondent of the false, misleading and deceptive representations set forth in Paragraph Fourteen has had and now has the capacity and tendency to mislead members of the public into the belief that such representations are true, and to induce by subterfuge the disclosure of private information about the debtor by reason of such erroneous and mistaken belief.

PAR. 17. In the course and conduct of its aforesaid business, and for the purpose of inducing payment on debts alleged by respondent to be delinquent, Avco, through its representatives, agents and employees has engaged in, and in some instances continues to engage in, conduct the natural consequence of which is to deceive the debtor or third party, including, but not limited to, making false, deceptive or misleading representations which include, among other things, falsely representing that the debtor has committed a crime or engaged in other conduct that would subject him to ridicule or disgrace. Therefore, the use of such acts and practices was and is misleading and deceptive.

PAR. 18. In the course and conduct of its business, and at all times mentioned herein, respondent has been and now is in substantial competition in or affecting commerce with corporations, firms and individuals engaged in the extension of consumer credit and the collection of debts arising therefrom.

PAR. 19. The acts and practices of respondent, as herein alleged, were and are all to the prejudice and injury of the public and of respondent's competitors, and constituted, and now constitute, unfair methods of competition and unfair and deceptive acts and practices in or affecting commerce in violation of Section 5 of the Federal Trade Commission Act, as amended.

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of complaint which the New York Regional Office proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Federal Trade Commission Act; and

The respondent, its attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, and admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it has reason to believe that the respondent has violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days and having duly considered the comments filed thereafter by interested persons pursuant to Section 2.34 of its Rules, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent Avco Financial Services, Inc. is a corporation organized, existing and doing business under and by virtue of the laws of the State of Delaware, with its office and principal place of business located at 620 Newport Center Drive, in the City of Newport Beach, State of California.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondents, and the proceeding is in the public interest.

ORDER

For the purposes of this order, the following definitions shall apply:

Definitions

A. *Avco Financial Services, Inc.*, means Avco Financial Services, Inc. and its subsidiaries, to the extent that such entities are engaged in the extension of consumer credit through the issuance of consumer loans, the refinancing of consumer's outstanding indebtedness and the acquisition of retail installment contracts, within the United States of America, its territories or possessions, and each officer, director, employee, agent or representative acting or purporting to act on its or their behalf.

B. *Subsidiary* means any domestic corporation or entity, fifty (50) percent or more of the outstanding voting shares of which are owned directly or indirectly by Avco Financial Services, Inc.

C. *Consumer loan* means a cash advance by Avco Financial Services, Inc., which is received by a consumer, for which the payment of a *finance charge* within the meaning of the Truth in Lending Act, 15 U.S.C. 1601, as amended, and Regulation Z, 16 CFR 226 (1980), is or may be required, and which is used primarily for personal, family or household purposes.

D. *Debtor* or *Consumer* means any natural person obligated or allegedly obligated to pay any debt, including any cosigner.

E. *Debt* shall mean any obligation or alleged obligation of a natural person to pay money to Avco Financial Services, Inc., in which the money, property or services which are the subject of the transaction which gave rise to the obligation are primarily used for personal, family or household purposes, whether or not such obligation has been reduced to judgment.

F. *Delinquent* means the state at which a debt is due and unpaid at the time fixed by contract.

G. *Collecting a debt* or *debt collection* means any activity other than the use of judicial process and the making of ancillary third party contacts which is intended to or does bring about repayment of all or part of a consumer debt.

H. *Ancillary third party contacts* means communications which are collateral to the direct debt collection process, including but not limited to, contacts with other creditors, submission of credit reports or credit inquiries to credit bureaus, and contacts with debt collection agencies, collection attorneys, bankruptcy attorneys and judicial and quasi-judicial authorities.

I. *Third party* means any natural person or entity not obligated to pay the debt which is the basis of the debt collection activity by Avco Financial Services, Inc.

J. *Location information* means a consumer's residence and his telephone number at such place, or his place of employment.

I.

It is ordered, That respondent Avco Financial Services, Inc., a corporation, its successors and assigns, and respondent's officers, agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in the course of collecting a debt, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, as amended, do forthwith cease and desist from:

a. Using obscene or profane language in conversations with debtors or third parties, or language or tone of voice the natural consequence of which is to harass, abuse or oppress the hearer.

b. Making repeated or continuous telephone calls with intent to harass, abuse or oppress the person at the called number.

c. Contacting or communicating with:

(1) Any person, by telephone or otherwise, at times or places known or which should be known by the contactor or communicator to be inconvenient to such person. Respondent shall assume that the convenient time for communicating with such person is after 8 o'clock AM and before 9 o'clock PM, local time at such person's location, unless respondent has knowledge of circumstances to the contrary.

(2) Any consumer's place of employment, by telephone or otherwise, where such contacts are known or should be known by the contactor or communicator to be objected to or prohibited by the consumer's employer.

(3) Any consumer, where respondent knows that the consumer is represented by an attorney acting on behalf of and in the name of the consumer with respect to the debt, and has knowledge of such attorney's name and address; *provided, however,* that respondent may communicate directly with the consumer if: 1) the attorney fails to respond to a communication from respondent within such time as prescribed by state law or, if state law is silent, within twenty-one (21) days, or 2) the attorney consents to direct communication with the consumer, or 3) the communication is made with the express permission of a court of competent jurisdiction.

(4) Any consumer if such person has notified respondent in writing that said consumer refuses to pay the debt or is not obligated to pay the debt and wishes respondent to cease further communication; except that respondent may transmit such written notices as are required by law and, in addition, may make one further contact after the initial notification by the consumer to cease further communication:

(i) To inform the consumer of the specified remedies which are ordinarily invoked by respondent; or

(ii) To pursue bona fide compromise and settlement negotiations which may continue upon the written consent of the consumer; or

(iii) To advise the consumer that respondent will cease further communication.

d. Using or threatening the use of force or violence to harm the physical person or property of any person.

e. Engaging in any conduct, the natural consequence of which is to deceive any person including, but not limited to, making any false, misleading or deceptive representation.

f. Engaging in any conduct the natural consequence of which is to harass, abuse or oppress any person including, but not limited to, repeated, substantial harassment and threatening that nonpayment will result in actions which are not intended to be taken or which cannot legally be taken, such as disclosure of the debt to third parties other than through ancillary third party contacts.

g. Contacting any third party in the course of collecting a debt without the express consent of the consumer given at the time of collecting the debt, except:

(1) The consumer's attorney.

(2) Third parties, for the purpose of acquiring location information where the whereabouts of the consumer are genuinely unknown and to make reasonable inquiries concerning the nature and extent of a consumer's property; *provided, however,* that no mention of the debt is made.

(3) Third parties, as permitted by a court of competent jurisdiction.

(4) Other creditors, credit reporting agencies, debt collection agencies, collection attorneys, bankruptcy attorneys and other judicial and quasi-judicial authorities.

For the purpose of this paragraph, the term *consumer* includes the consumer's spouse, parent (if the consumer is a minor), guardian, executor, or administrator.

h. Misrepresenting the business, company or personal identity of respondent or its employees.

Provided, That it shall be permissible under this paragraph for respondent's representatives, agents or employees to identify themselves in accordance with regularly used pseudonyms which are recorded, and said records are maintained by respondent for a period of three (3) years.

i. Representing, directly or by implication, either orally or in writing, that (1) nonpayment of a debt will result in respondent instituting or causing to be instituted legal action against the debtor and/or (2) nonpayment of a debt will result in respondent seizing or repossessing or causing to be seized or repossessed a consumer's property unless respondent can show that it intended to take the represented action at the time such representation was made.

Intent may be determined by any of the following factors: (1) whether respondent had issued a *bona fide* authorization to take such action at the time of the representation; (2) whether respondent ordinarily takes such action in similar circumstances; or (3) other factors and circumstances which demonstrate that respondent intended to take the represented action.

Further, respondent shall cease and desist from representing, directly or by implication, that respondent or any third party may take any action unless respondent can show that at the time the representation was made there was a reasonable likelihood of such action occurring.

II.

It is further ordered, That respondent Avco Financial Services, Inc., its successors and assigns, and respondent's officers, agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in the course of collecting a debt, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, as amended shall maintain and at all times comply with a plan for collecting debts which shall provide for:

(a) Policies and procedures which explicitly prohibit such debt collection practices as are specified as unfair or deceptive in the complaint here attached or otherwise prohibited by federal law.

(b) The training of all such respondent's personnel as reasonably may engage in debt collection activities with respect to the policies and procedures set forth in subparagraph (a) above.

(c) The maintenance of a toll-free customer service telephone number at respondent's principal place of business for the receipt of complaints regarding respondent's acts and practices in connection with its debt collection activities within such States of the United States as are denominated as states of the date this order becomes final.

(d) Distribution of the following notice to consumers within such States of the United States as are denominated as states as of the date this order becomes final:

> The law prohibits unfair or deceptive debt collection practices. These practices include harassment, abuse, improper disclosure of the debt to other persons and threats to take legal action which is not intended to be taken. If you have any complaints about the way we are collecting this debt, contact our branch manager (phone number on front) or call our *toll-free* customer service number (all U.S. except California 800-854-3883 - California only 800-432-7025). You may also write to Avco Financial Services, Customer Service Department, P.O. Box 2210, Newport Beach, CA 92663 or the Federal Trade Commission, Correspondence Branch, 6th and Pennsylvania Ave., N.W., Washington, D.C. 20580, or your state Attorney General.

Said notice shall be transmitted to consumers on each computer generated acknowledgement of receipt of payment and/or computer generated statement of account on an outstanding debt (receipt/statement). The notice shall be provided in the identical type size, position and manner as it is displayed on attached Appendix "A". The color of ink used shall be the same as that used for the other preprinted information or darker.

In addition, the statement IMPORTANT: SEE OVER ABOUT

YOUR RIGHTS shall be clearly and conspicuously printed on the front side of said receipt/statement in the identical type size, position and manner as it is displayed on attached Appendix "B" and in the same color ink as that used for other pre-printed information or darker.

(e) Distribution of the following notice on informational material accompanying the first receipt/statement:

Unfair or deceptive collection practices, including harassment, abuse, improper disclosure of the debt to other persons and threats to take legal action which is not intended, are prohibited by law. See reverse side of the ____________________ Statement for further information.

An appropriate descriptive term denominating the receipt/statement and consistent with the term used on said informational material shall be inserted in the notice prior to the word "Statement".

Said notice shall be clearly and conspicuously provided in the identical type size, position and manner as it is displayed on attached Appendix "E". The notice shall be in red so long as other information is principally provided in blue; if blue is not used the designated notice shall be printed in a distinctive and contrasting color.

(f) Distribution of the following notice to consumers not within such states of the United States as are denominated as states as of the date this order becomes final:

The law prohibits unfair or deceptive debt collection practices. These practices include harassment, abuse, improper disclosure of the debt to other persons and threats to take legal action which is not intended to be taken. If you have any complaints about the way we are collecting this debt, contact our branch manager. You may also write to Avco Financial Services, Customer Service Department, P.O. Box 2210, Newport Beach, California 92663 or the Federal Trade Commission, Correspondence Branch, 6th and Pennsylvania Avenue, N.W., Washington, D.C., 20580 or your Attorney General.

Said notice shall be clearly and conspicuously provided on the reverse side of delinquency notices regularly sent to past due accounts in the same manner and type size as displayed on Appendix "C". In addition, the statement IMPORTANT: SEE OVER ABOUT YOUR RIGHTS shall be clearly and conspicuously printed on the front side of said notice in the same manner and type size as displayed on Appendix "D" but with the word "Important" in a different and distinctive color from the balance of the required statement. For all debt collection activities conducted in Puerto Rico the above notices shall be provided in Spanish on Spanish language delinquency notices. The Spanish translation of the notice shall be approved by the Division of Enforcement, Bureau of Consumer Protection, Federal Trade Commission prior to its initiation.

(g) The resolution of each complaint received by respondent, either oral or written, within ninety (90) days from the receipt of such complaint.

(h) Maintenance of a record, in writing, of each complaint, oral or written, received by respondent regarding the following debt collection practices: use of obscenity or profanity; harassment, abuse, deception, or coercion; repeated or continuous telephone calls; contacts at inconvenient times or places or at places of employment, or when a consumer is represented by an attorney; contacts when a consumer has requested that further communication cease; use or threat of use of force or violence; the making of false, misleading or deceptive representations; threats to take legal action; contacts with third parties; and misrepresentation of the business, company or personal identity of the company or its employees.

The record shall be maintained without regard to the method by which the complaint was received. Said record shall show the name, telephone number and account number (if applicable) of the complainant, date and place of filing, a brief description of the complaint, and the location of the branch office(s) involved in the subject matter of the documents relating to the complaint shall be retained for three (3) years from the date the complaint was received. If the written record is compiled or maintained at a location other than the respondent's principal place of business, a copy of said record shall, within a reasonable period of time after its compilation, be transmitted to and maintained at respondent's principal place of business for three (3) years from the date the complaint was received.

(i) Maintenance of a record of each communication by respondent made or attempted with any person in the course of collecting a debt. Said record shall include, with regard to each such communication, an identification of such person and the date of the communication. With respect to written communications, a copy of said communication must be retained in the file of the debtor; *provided, however,* that if a form document is used, it will be adequate to designate the name or number of the form. The recordkeeping required by this subparagraph shall either utilize a uniform notation system for which a key to decoding is maintained, or be kept in such a manner as to be understandable by a person not familiar with respondent's notation system. Each record shall be retained for a period of three (3) years after the date of such contact.

(j) Disciplinary sanctions for violation of respondent's collection procedures.

III.

It is further ordered, That:

(a) Respondent shall permit access by the Commission, to any of its debt collection records upon reasonable notice and at reasonable hours. Respondent may provide the original documents or exact copies in lieu of access.

(b) In the event that the Federal Trade Commission promulgates a Trade Regulation Rule applicable to respondent's third party contact activities, compliance with that rule shall be deemed to be compliance with Section II(f) of this order.

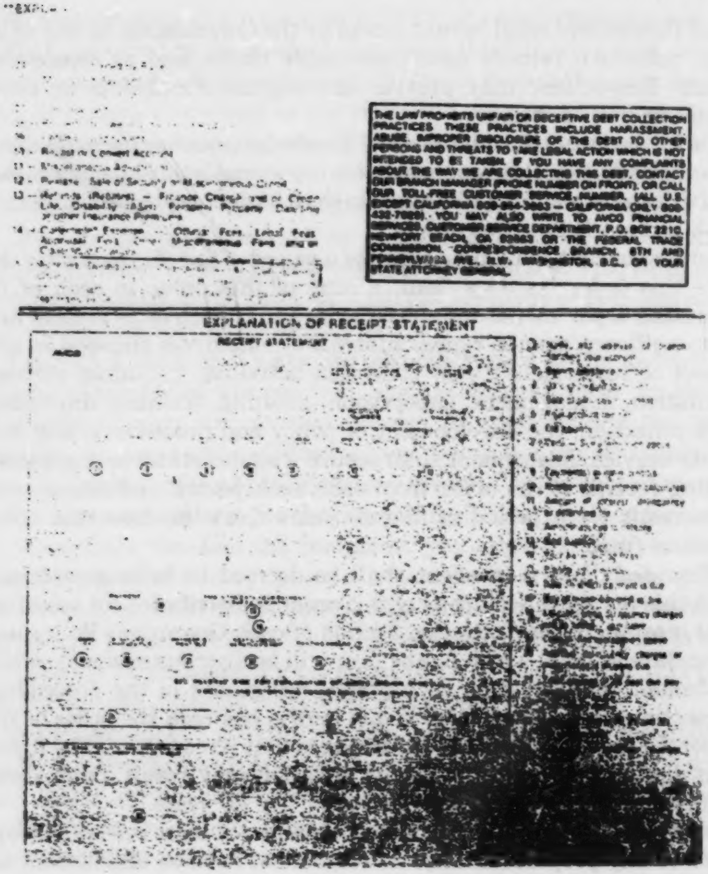
(c) Respondent shall distribute, for a period of five (5) years after the date this order becomes final, a copy of this order to each of its operating departments and subsidiaries and to each of its present and future officers, agents, representatives or employees engaged in any aspect of respondent's debt collection activities, including without limitation, management, supervision, auditing, training, day-to-day debt collection, the development of policy and procedures, and customer service. Respondent shall secure a signed statement acknowledging receipt of the order from each such person and retain such statements for a period of five (5) years from the date this order becomes final.

Provided, That respondent shall be deemed to be in compliance with this paragraph if a copy of this order is distributed for insertion or is inserted in the Collection Section of each Operations Policy and Procedure Manual which has been or will be distributed and a signed statement obtained from each person designated in the proceeding subsection which specifies that said person has read the order of the Federal Trade Commission, understands that Avco is bound by it and that disciplinary sanctions for its violation may result. Such statements must be retained for a period of five (5) years.

(d) Respondent shall notify the Commission at least thirty (30) days prior to any proposed change in respondent such as dissolution, assignment or sale resulting in the emergence of a successor corporation(s), or any other change, including the creation or dissolution of subsidiaries, if any such changes may affect compliance obligations arising out of this order.

(e) Respondent shall, within one hundred twenty (120) days after service upon it of this order, file with the Commission a report, in writing, setting forth in detail the manner and form in which it has complied with this order.

EXHIBIT A



10 – Rebate on Current Account

11 – Miscellaneous Adjustment

12 – Release – Sale of Security or Miscellaneous Credit

13 – Refunds (Rebates) – Finance Charge and/or Credit Life, Disability (A&H), Personal Property, Dwelling or other Insurance Premiums

14 – Collateral Expense – Official Fees, Legal Fees, Appraisal Fees, Other Miscellaneous Fees and/or [illegible]

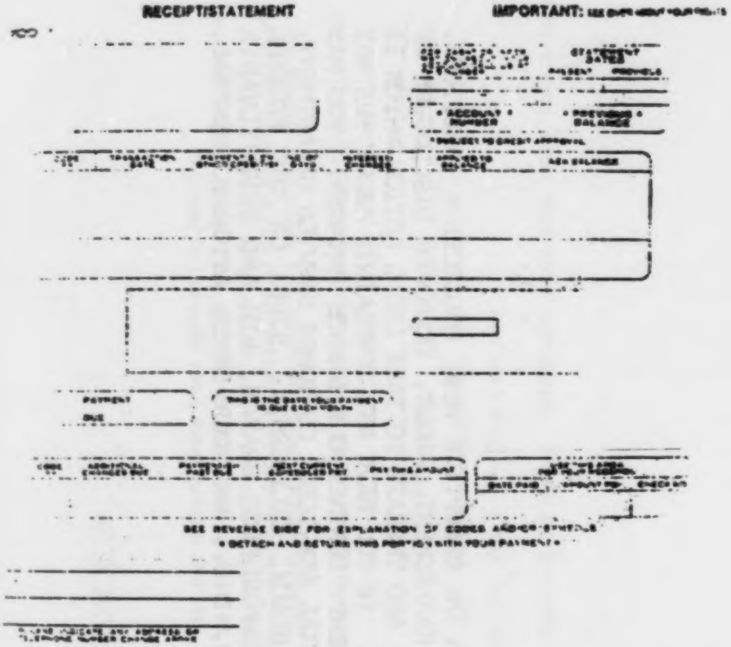
THE LAW PROHIBITS UNFAIR OR DECEPTIVE DEBT COLLECTION PRACTICES. THESE PRACTICES INCLUDE HARASSMENT, ABUSE, IMPROPER DISCLOSURE OF THE DEBT TO OTHER PERSONS AND THREATS TO TAKE LEGAL ACTION WHICH IS NOT INTENDED TO BE TAKEN. IF YOU HAVE ANY COMPLAINTS ABOUT THE WAY WE ARE COLLECTING THIS DEBT, CONTACT OUR BRANCH MANAGER (PHONE NUMBER ON FRONT), OR CALL OUR TOLL-FREE CUSTOMER SERVICE NUMBER, (ALL U.S. EXCEPT CALIFORNIA 800-854-3663 — CALIFORNIA ONLY 800-432-7080). YOU MAY ALSO WRITE TO AVCO FINANCIAL SERVICES, CUSTOMER SERVICE DEPARTMENT, P.O. BOX 2210, NEWPORT BEACH, CA 92663 OR THE FEDERAL TRADE COMMISSION, CORRESPONDENCE BRANCH, 6TH AND PENNSYLVANIA AVE., N.W. WASHINGTON, D.C., OR YOUR STATE ATTORNEY GENERAL.

EXPLANATION OF RECEIPT STATEMENT

RECEIPT STATEMENT

AVCO

EXHIBIT B



RECEIPT/STATEMENT

IMPORTANT:

STATEMENT DATES

PRESENT PREVIOUS

ACCOUNT NUMBER

PREVIOUS BALANCE

SUBJECT TO CREDIT APPROVAL

NEW BALANCE

PAYMENT DUE

THIS IS THE DATE YOUR PAYMENT IS DUE EACH MONTH

CODE

ADDITIONAL CHARGES DUE

PAY THIS AMOUNT

DATE PAID

AMOUNT PAID

CHECK NO.

SEE REVERSE SIDE FOR EXPLANATION OF CODES AND/OR SYMBOLS

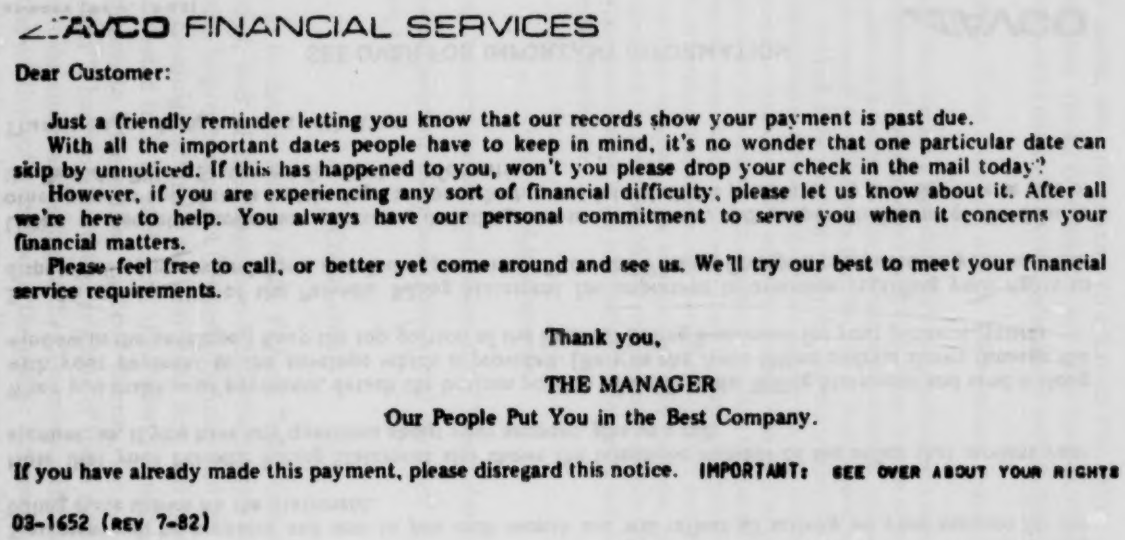
DETACH AND RETURN THIS PORTION WITH YOUR PAYMENT

PLEASE INDICATE ANY ADDRESS OR TELEPHONE NUMBER CHANGE ABOVE

EXHIBIT C

THE LAW PROHIBITS UNFAIR OR DECEPTIVE DEBT COLLECTION PRACTICES. THESE PRACTICES INCLUDE HARASSMENT, ABUSE, IMPROPER DISCLOSURE OF THE DEBT TO OTHER PERSONS AND THREATS TO TAKE LEGAL ACTION WHICH IS NOT INTENDED TO BE TAKEN. IF YOU HAVE ANY COMPLAINTS ABOUT THE WAY WE ARE COLLECTING THIS DEBT, CONTACT OUR BRANCH MANAGER. YOU MAY ALSO WRITE TO AVCO FINANCIAL SERVICES, CUSTOMER SERVICE DEPARTMENT, P.O. BOX 2210, NEWPORT BEACH, CALIFORNIA 92663 OR THE FEDERAL TRADE COMMISSION, CORRESPONDENCE BRANCH, 6TH AND PENNSYLVANIA AVENUE, N.W., WASHINGTON, D.C., OR YOUR STATE ATTORNEY GENERAL.

EXHIBIT D



AVCO FINANCIAL SERVICES

Dear Customer:

Just a friendly reminder letting you know that our records show your payment is past due.

With all the important dates people have to keep in mind, it's no wonder that one particular date can skip by unnoticed. If this has happened to you, won't you please drop your check in the mail today?

However, if you are experiencing any sort of financial difficulty, please let us know about it. After all we're here to help. You always have our personal commitment to serve you when it concerns your financial matters.

Please feel free to call, or better yet come around and see us. We'll try our best to meet your financial service requirements.

Thank you,

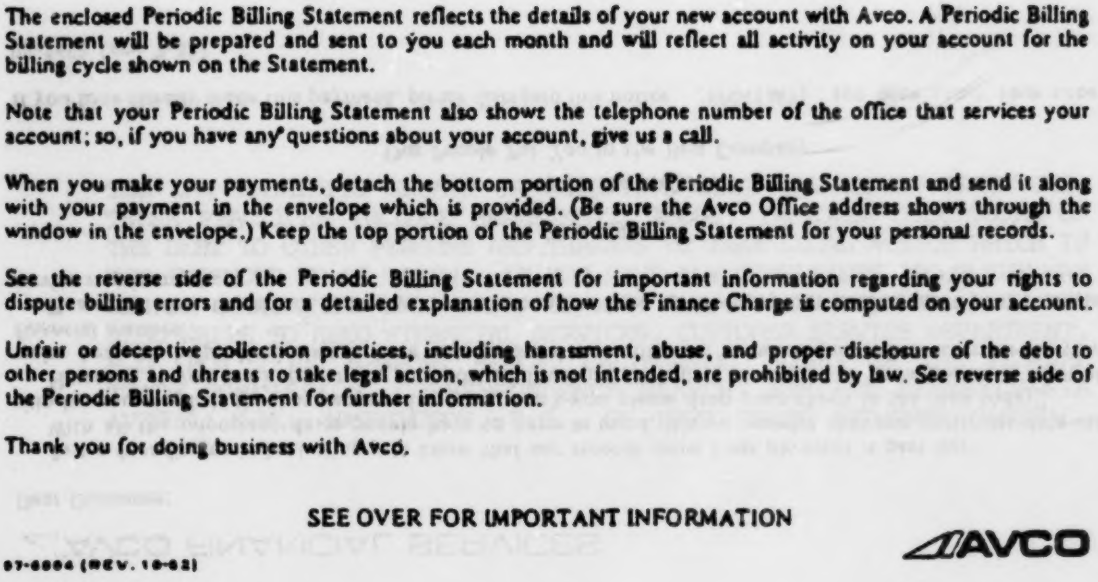
THE MANAGER

Our People Put You in the Best Company.

If you have already made this payment, please disregard this notice. IMPORTANT: SEE OVER ABOUT YOUR RIGHTS

03-1652 (REV 7-82)

EXHIBIT E



The enclosed Periodic Billing Statement reflects the details of your new account with Avco. A Periodic Billing Statement will be prepared and sent to you each month and will reflect all activity on your account for the billing cycle shown on the Statement.

Note that your Periodic Billing Statement also shows the telephone number of the office that services your account; so, if you have any questions about your account, give us a call.

When you make your payments, detach the bottom portion of the Periodic Billing Statement and send it along with your payment in the envelope which is provided. (Be sure the Avco Office address shows through the window in the envelope.) Keep the top portion of the Periodic Billing Statement for your personal records.

See the reverse side of the Periodic Billing Statement for important information regarding your rights to dispute billing errors and for a detailed explanation of how the Finance Charge is computed on your account.

Unfair or deceptive collection practices, including harassment, abuse, and proper disclosure of the debt to other persons and threats to take legal action, which is not intended, are prohibited by law. See reverse side of the Periodic Billing Statement for further information.

Thank you for doing business with Avco.

SEE OVER FOR IMPORTANT INFORMATION

AVCO

87-6004 (REV. 10-82)

IN THE MATTER OF

PEABODY BARNES, INC.

CONSENT ORDER, ETC., IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT AND THE MAGNUSON-MOSS WARRANTY-FEDERAL TRADE COMMISSION IMPROVEMENT ACT

Docket C-3142. Complaint, Aug. 15, 1984—Decision, Aug. 15, 1984

This consent order requires a Mansfield, Ohio manufacturer and seller of sump and sewage pumps and pump systems, among other things, to cease offering a warranty whose duration is measured from the date of manufacture, unless the warranty coverage extends for three years from the date of manufacture, or the company clearly discloses in the warranty, either the date the product was manufactured or an explanation as to how a customer can discover the date of manufacture. Any representation that a product's warranty coverage runs for a certain time is prohibited, unless the warranty will actually be in effect for that period. The order also requires respondent to treat every claim for warranty service made within 12 months of installation as timely, regardless of the product's date of manufacture, if the warranty document is not in compliance with this order; issue warranties that comply with the Magnuson-Moss Warranty Act; and send a notice explaining the revisions and changes in the company's warranty policy and documents to its dealers and distributors.

Appearances

For the Commission: *Rachel Miller* and *Christopher R. Brewster.*

For the respondent: *Stephen Greiner* and *Mitchell J. Auslander,* New York City.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, as amended, and of the Magnuson-Moss Warranty-Federal Trade Commission Improvement Act ("Warranty Act") and the implementing Rules promulgated under the Warranty Act, and by virtue of the authority vested in it by said Acts, the Federal Trade Commission, having reason to believe that Peabody Barnes, Inc., a corporation ("respondent"), has violated the provisions of those Acts and implementing Rules, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

I

Paragraph 1. Respondent Peabody Barnes, Inc., is a corporation organized, existing, and doing business under and by virtue of the laws of the State of Ohio, with its office and principal place of business located at 1651 North Main Street, Mansfield, Ohio.

Par. 2. Respondent is and has been engaged in the manufacture, distribution, offering for sale and sale of sump pumps, sewage pumps, and other pumps and pump systems. Respondent causes and has caused these products to be shipped into more than 45 states for sale to the public. Respondent therefore maintains and has maintained a substantial course of trade in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, as amended.

Par. 3. In the course and conduct of its business, respondent offers and has offered warranties to retail purchasers. These warranties accompany each individual product item.

Par. 4. These warranties typically, and by way of illustration, state, in pertinent part:

> *One Year Warranty*- Peabody Barnes warrants each [type of product] for a period of one (1) year from the date of installation, or 18 months from the date of manufacture, whichever comes first. . . .

Par. 5. Respondent disseminates and has disseminated, to distributors, dealers or others, materials describing its warranties as "one-year warranty" or "standard one-year warranty."

Par. 6. Through the acts, practices, statements and representations alleged in Paragraphs Three through Five above, respondent represents and has represented, expressly or by implication, that respondent provides purchasers with a one-year warranty.

Par. 7. In truth and in fact, a substantial number of respondent's products are and have been first sold at retail more than six months after manufacture, and a substantial number are and have been first sold at retail more than eighteen months after manufacture. Thus, since the warranty on a product expires eighteen months after manufacture, a substantial number of purchasers receive and have received less than a year of coverage under the warranty, or no coverage whatsoever.

Par. 8. The statements, representations, acts, and practices alleged in Paragraphs Three through Seven above have and have had the capacity and tendency to mislead members of the public into the erroneous and mistaken belief that those statements and representations are true and complete, and to induce a substantial number of such persons to purchase respondent's products by reason of this erroneous and mistaken belief.

PAR. 9. The acts and practices of respondent alleged in Paragraphs Three through Eight above are all to the prejudice and injury of the public, and constitute deceptive acts or practices in or affecting commerce, in violation of Section 5(a)(1) of the Federal Trade Commission Act, as amended.

II

The allegations of Paragraphs One through Nine above are incorporated by reference in this Part as though fully set forth below.

PAR. 10. In the course and conduct of its business, respondent is and has been a supplier of consumer products distributed in commerce, as "supplier," "consumer product," and "commerce" are defined in the Warranty Act. Respondent offers and has offered written warranties, as described in Paragraphs Three and Four above, to consumers on these consumer products, and therefore is and has been a warrantor, as "written warranty," "consumer," and "warrantor" are defined in that Act.

PAR. 11. Respondent fails and has failed to disclose the dates of manufacture of its products to retail purchasers or prospective purchasers.

PAR. 12. Respondent's failure to disclose the date of manufacture of an item, where the duration of respondent's warranty on the item may depend on that date, constitutes a failure to contain a statement of the duration of respondent's warranty on the item.

PAR. 13. The statement of duration of a warranty is information which is necessary, in light of all the circumstances, to make the warranty not misleading to a reasonable individual exercising due care.

PAR. 14. Respondent's warranty, which fails to contain a statement of duration as alleged in Paragraphs Eleven through Thirteen above, is a "deceptive warranty" as defined in Section 110(c)(2)(A)(ii) of the Warranty Act.

PAR. 15. As alleged in Paragraphs Six and Seven above, respondent's warranty represents that its duration is one year, a representation which is false in a substantial number of cases. The warranty thus contains a representation which is false or which would, in light of all the circumstances, mislead a reasonable individual exercising due care. The warranty is therefore a "deceptive warranty" as defined in Section 110(c)(2)(A)(i) of the Warranty Act.

PAR. 16. As alleged in Paragraphs Four through Seven above, the term of respondent's warranty limiting its duration to eighteen months from date of manufacture causes the warranty to expire prior to the first retail sale of the warranted product in a substantial number of cases. The term thus so limits the scope and application of the warranty as to deceive a reasonable individual. The warranty is therefore a "deceptive warranty" as defined in Section 110(c)(2)(B) of the Warranty Act.

PAR. 17. Pursuant to Sections 110(c)(1) and 110(b) of the Warranty Act, respondent's deceptive warranty, as alleged in Paragraphs Fourteen through Sixteen above, violates Section 5(a)(1) of the Federal Trade Commission Act, as amended.

PAR. 18. Respondent's failure, as alleged in Paragraphs Eleven and Twelve above, to disclose the durations of those written warranties offered to consumers on consumer products manufactured after December 31, 1976, and actually costing consumers more than $15, is and has been in violation of Section 701.3(a)(4) of the rule on Disclosure of Written Consumer Product Warranty Terms and Conditions, 16 CFR Part 701, implementing Section 102(a) of the Warranty Act. Pursuant to Section 110(b) of that Warranty Act, respondent's failure to disclose the duration of those written warranties also is and has been in violation of Section 5(a)(1) of the Federal Trade Commission Act, as amended.

PAR. 19. In written warranty documents provided to consumers on consumer products manufactured after December 31, 1976, and actually costing consumers more than $15, respondent fails and has failed to make the disclosures required by and set forth in Sections 701.3(a)(8) and 701.3(a)(9) of the rule on Disclosure of Written Consumer Product Warranty Terms and Conditions, 16 CFR 701, implementing Section 102(a) of the Warranty Act. These failures are and have been in violation of the Warranty Act, and, pursuant to Section 110(b) of that Act, in violation of Section 5(a)(1) of the Federal Trade Commission Act, as amended.

PAR. 20. In written warranty documents provided to consumers on consumer products manufactured after July 4, 1975, respondent includes and has included the following term:

> The company makes no additional warranties, expressed or implied, of merchantability or fitness. . . .

This statement constitutes a disclaimer of implied warranties in violation of Section 108 of the Warranty Act, and, pursuant to Section 110(b) of the Warranty Act, in violation of Section 5(a)(1) of the Federal Trade Commission Act, as amended.

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of complaint which the Bureau of Consumer Protection proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondents with violation of the Magnuson-Moss Warranty—Federal Trade Commission Improvement Act and the Federal Trade Commission Act; and

The respondent, its attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondent has violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent Peabody Barnes, Inc., is a corporation organized, existing and doing business under and by virtue of the laws of the State of Ohio, with its office and principal place of business located at 1651 North Main Street, in the City of Mansfield, State of Ohio.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

I

It is ordered, That respondent Peabody Barnes, Inc., a corporation, its successors and assigns, and respondent's officers, agents, representatives, and employees, directly or through any corporation, subsidiary, division, or other device, in connection with the offering for sale, sale or distribution of any pump or pump system in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, as amended, do forthwith cease and desist from:

A. Offering on any such pump or pump system a warranty whose duration is measured from date of manufacture, unless:

1. The period measured from date of manufacture is at least 36 months, and

2. Respondent discloses clearly and conspicuously in the warranty document either:

a. The date of manufacture of the item warranted, or

b. An explanation of how a customer can discover the date of manufacture from a simple visual inspection of the item, exclusive of packaging.

B. Representing, directly or by implication, that a warranty on any such pump or pump system runs for a certain period (*e.g.,* by calling it a one-year warranty), unless the warranty on that item will actually be in effect for that period (beginning on the date of sale or installation of the item, unless the representation clearly and conspicuously states otherwise).

II

It is further ordered, That respondent, its successors and assigns, and respondent's officers, agents, representatives, and employees, directly or through any corporation, subsidiary, division, or other device, in connection with the offering for sale, sale or distribution of any pump or pump system in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, as amended, shall treat every claim for warranty service made within 12 months of installation as timely, regardless of the date of manufacture, for any such pump or pump system sold by respondent prior to the date of service of this order with a warranty document not in compliance with this order.

III

The definitions contained in Section 101 of the Magnuson-Moss Warranty Act (15 U.S.C. 2301) shall apply to the terms used in this Part.

It is further ordered, That respondent, its successors and assigns, and respondent's officers, agents, representatives, and employees, directly or through any corporation, subsidiary, division, or other device, in connection with the offering for sale, sale or distribution of any consumer product in or affecting commerce, do forthwith cease and desist from:

A. In any written warranty, disclaiming any implied warranty, or modifying any implied warranty in a manner prohibited by Section 108 of the Magnuson-Moss Warranty Act (15 U.S.C. 2308);

B. In any written warranty to which the rule on Disclosure of Written Consumer Product Warranty Terms and Conditions (16 CFR 701) applies, failing to make all disclosures required by that rule, in the manner and form specified therein, and as that rule may be amended, including, but not limited to, all disclosures required by Sections 701.3(a)(8) and 701.3(a)(9) of that rule.

IV

It is further ordered, That, within 30 days after the date of service of this order respondent shall provide notice in writing to all current dealers and distributors of any of respondent's products who are known to respondent, as follows:

A. An explanation of revisions in the current warranty documents made to comply with Parts I.A., III.A, and III.B of this order. In regard to Part III.A of this order, the notice shall briefly explain that respondent's warranty no longer contains a disclaimer of implied warranties; that respondent recognizes that in some cases customers may have rights in addition to those in the written warranty; and that if a dealer or distributor believes a situation may call for assistance beyond the written warranty terms, or if a customer requests such assistance, the matter should be referred to respondent for its consideration.

B. A statement that respondent will honor valid warranty claims for one year after installation, regardless of date of manufacture, for any product distributed prior to the date of service of this order with an unrevised warranty document.

C. An instruction that dealers and distributors refrain from stating or implying that respondent's warranty on any pump or pump system runs for a certain period (*e.g.*,by calling it a one-year warranty), unless the warranty on the item will actually be in effect for that period (beginning on the date of sale or installation of the item, unless the representation clearly and conspicuously states otherwise).

V

It is further ordered, That respondent shall distribute a copy of this order to all of respondent's divisions and to all present and future personnel, agents or representatives of respondent having responsibilities with respect to the subject matter of this order.

VI

It is further ordered, That respondent shall notify the Commission at least thirty (30) days prior to any proposed change in the corporate respondent such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change in the corporation which may affect compliance obligations arising out of the order.

VII

It is further ordered, That respondent shall, within sixty (60) days after service upon it of this order, file with the Commission a report, in writing, setting forth in detail the manner and form in which it has complied with this order.

IN THE MATTER OF

GENERAL MOTORS CORPORATION, ET AL.

MODIFYING ORDER IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket 8907. Final Order, Jan. 10, 1975—Modifying Order, Aug. 16, 1984

This order reopens the proceeding and modifies the Commission's 1975 Cease and Desist Order which barred a motor vehicle manufacturer and its advertising agency [85 F.T.C. 27] from making superior handling claims for any automobile, unless the claims were substantiated by scientific tests. In response to petitions from both respondents, the Modifying Order redefines the term "handling" as it relates to the control of a moving automobile; adds a paragraph defining the phrase "vehicle handling characteristics;" clarifies the definition of the scientific tests required for substantiating comparative claims; and permits respondents to make superiority claims regarding one or more specifically identified vehicle handling characteristics without having to raise substantiation requirements for other handling characteristics.

ORDER REOPENING PROCEEDING AND MODIFYING CEASE AND DESIST ORDER

On April 19, 1984 General Motors Corporation [hereinafter G.M.C.], a respondent in the above captioned matter, filed a petition pursuant to Rule 2.51 of the Commission's Rules of Practice to reopen the above-captioned proceeding and modify the order entered therein (85 F.T.C. 32). On May 7, 1984 Campbell-Ewald Company, an advertising agency for G.M.C. and also a respondent in the above matter, filed a petition to reopen and modify the order entered against Campbell-Ewald (85 F.T.C. 35).

The order, which was entered in 1975, prohibits the respondents from representing that any automobile is superior in handling to any other automobile or all other automobiles unless respondents have a reasonable basis for such representations. Handling is defined in terms of the response of the vehicle:

(a) under conditions where rapid steering inputs in evasive or emergency maneuvers are necessary;

(b) under cornering conditions at speeds in excess of 30 miles per hour in which levels of lateral acceleration in excess of .2g are attained; and

(c) in gusty crosswinds, on rough roads and under severe steering-braking conditions.

Respondents now seek to modify the order by, inter alia, substituting a new definition for handling, adding a new paragraph defining vehicle handling characteristics, and adding a further clarification to the definition of scientific test. The modified order would permit respondents to advertise specific aspects concerning the comparative handling of motor vehicles, without having to prove overall handling superiority.

The Commission has concluded that, to avoid any unintended restriction on the dissemination to the public of information material to purchasing decisions, the petitions are in the public interest and should be granted. The proposed modified order will continue to require that respondents have a reasonable basis for vehicle handling claims.

It is therefore ordered, That the proceeding is hereby reopened and the Decision and Order issued January 10, 1975, in Docket No. 8907 is hereby modified to read as follows:

DECISION AND ORDER AS TO GENERAL MOTORS CORPORATION

I.

It is ordered, That respondent General Motors Corporation, a corporation, its successors and assigns, and its officers, agents, representatives, and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, offering for sale, sale or distribution of any automobile, in commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

1. Representing, directly or by implication, in any manner including the use of any endorsement, testimonial, or statement made by any individual, group, or organization, that any automobile is superior to any other automobile or all other automobiles in handling, or that any automobile exhibits one or more vehicle handling characteristics superior to the vehicle handling characteristics of any other automobile or all other automobiles, unless at the time such representation is first disseminated:

(a) respondent has a reasonable basis for such representation, which shall consist of a competent scientific test or tests that substantiate such representation; and

(b) respondent's agents, employees or representatives who are responsible for engineering approval of any advertisement containing such representation rely on such test or tests in approving such advertisement and provide to respondent's agents, employees or representatives who are responsible for approval of such advertisement a written statement that such reasonable basis exists which substantiates the representation.

2. Failing to maintain and produce accurate records which may be inspected by Commission staff members upon reasonable notice:

(a) which consist of the documentation constituting the reasonable basis required by Paragraph I.1 of this Order and which demonstrate that respondent's representatives relied on such reasonable basis as required in Paragraph I.1(b); and

(b) which shall be maintained for a period of three (3) years from the date on which any advertisement containing any such representation was last disseminated.

II.

It is further ordered, That for the purposes of Paragraph I of this Order, the following definitions shall apply:

1. *Handling*

The term *handling* is defined as the interaction of the driver, automobile, road, and environment as it relates to the control of a moving automobile.

2. *Vehicle Handling Characteristics*

The term *vehicle handling characteristics* is defined as the separately identifiable vehicle attributes which influence the automobile's contribution to handling. Vehicle handling characteristics include numerous vehicle attributes, such as, but not limited to, steering sensitivity, roll compliance, lateral acceleration response time, steering effort, maximum lateral acceleration, and task performance maneuvering capability.

3. *Scientific Test*

The term *scientific test* is defined and construed in accordance with the Federal Trade Commission's Order as stated in *Firestone Tire & Rubber Co.*, Docket No. 8818. [81 F.T.C. at 463]

> In our view a scientific test is one in which persons with skill and expertise in the field conduct the test and evaluate its results in a disinterested manner using testing procedures generally accepted in the profession which best insure accurate results. This is not to say that respondent always must conduct laboratory tests. The appropriate test depends on the nature of the claim made. Thus a road or user test may be an adequate scientific test to substantiate one performance claim, whereas a laboratory test may be the proper test to substantiate another claim. Respondent's obligation is to assure that any claim it makes is adequately substantiated by the results of whatever constitutes a scientific test in those circumstances.

Scientific tests for claims of superiority in handling or vehicle handling characteristics shall include reliable measures to control the variable influences of the driver, road, and environment so that the contribution of the automobile or of a specific vehicle attribute, can be identified.

III.

It is further ordered, That for the purposes of Paragraph I of this Order a statement about handling or any vehicle handling characteristic implies superiority if the statement is phrased in the comparative or superlative degree, or if any advertising containing such statement conveys a net impression of comparative superiority; *provided, however,* that any statement or statements in such advertising phrased in the comparative or superlative degree regarding any subject other than handling or vehicle handling characteristics will not, for that reason alone and without a statistically valid consumer survey, render any statement in such advertising which does relate to the handling or the vehicle handling characteristics of a vehicle and which is phrased in the positive degree to be deemed a representation that handling or vehicle handling characteristic of the vehicle are superior to any other vehicle or all other vehicles. A representation of superiority with respect to one or more specifically identified vehicle handling characteristics shall not give rise to any substantiation requirements with respect to any other vehicle handling characteristic.

IV.

It is further ordered, That respondent General Motors Corporation shall forthwith distribute a copy of this Modified Order to each of its officers, agents, representatives, or employees who are engaged in the creation or approval of advertisements.

V.

It is further ordered, That respondent General Motors Corporation notify the Commission at least thirty (30) days prior to any proposed change in said corporate respondent such as dissolution, assignment, or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change in the corporation which may affect compliance obligations arising out of this Modified Order.

VI.

It is further ordered, That respondent shall within sixty (60) days after service upon it of this Modified Order, file with the Commission a report, in writing, setting forth in detail the manner and form in which it has complied with this Modified Order.

DECISION AND ORDER AS TO CAMPBELL-EWALD COMPANY

I.

It is ordered, That respondent Campbell-Ewald Company, a corporation, its successors and assigns, and its officers, agents, representatives, and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, offering for sale, sale or distribution of any automobile, in commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

1. Representing, directly or by implication, in any manner including the use of any endorsement, testimonial, or statement made by any individual, group, or organization, that any automobile is superior to any other automobile or all other automobiles in handling, or that any automobile exhibits one or more vehicle handling characteristics superior to the vehicle handling characteristics of any other automobile or all other automobiles, unless at the time such representation is first disseminated:

(a) respondent or its client has a reasonable basis for such representation which shall consist of a competent scientific test or tests that substantiate such representation; or

(b) respondent has a reasonable basis for such representation which shall consist of an opinion in writing signed by a person qualified by education and experience to render such an opinion (who, if qualified by education and experience, may be a person retained or employed by respondent's client) that a competent scientific test or tests exist to substantiate such representation, *provided,* that any such opinion also discloses the nature of such test or tests and *provided further,* that respondent neither knows nor has reason to know that such test or tests do not in fact substantiate such representation or that any such opinion does not constitute a reasonable basis for such representation;

2. Failing to maintain and produce accurate records which may be inspected by Commission staff members upon reasonable notice:

(a) which consist of the documentation constituting the reasonable basis required by Paragraph I.1 of this Order; and

(b) which shall be maintained for a period of three (3) years from the date on which any advertisement containing any such representation was last disseminated by respondent.

II.

It is further ordered, That for the purposes of Paragraph I of the Order, the following definitions shall apply:

1. *Handling*

The term *handling* is defined as the interaction of the driver, automobile, road, and environment as it relates to the control of a moving automobile.

2. *Vehicle Handling Characteristics*

The term *vehicle handling characteristics* is defined as the separately identifiable vehicle attributes which influence the automobile's contribution to handling. Vehicle handling characteristics include numerous vehicle attributes, such as, but not limited to, steering sensitivity, roll compliance, lateral acceleration response time, steering effort, maximum lateral acceleration, and task performance maneuvering capability.

3. *Scientific Tests*

The term *scientific test* is defined and construed in accordance with the Federal Trade Commission's Order as stated in *Firestone Tire & Rubber Company,* Docket No. 8818. [81 F.T.C. at 463]

> In our view a scientific test is one in which persons with skill and expertise in the field conduct the test and evaluate its results in a disinterested manner using testing procedures generally accepted in the profession which best insure accurate results. This is not to say that respondent always must conduct laboratory tests. The appropriate test depends on the nature of the claim made. Thus a road or user test must be an adequate scientific test to substantiate one performance claim, whereas a laboratory test may be the proper test to substantiate another claim. Respondent's obligation is to assure that any claim it makes is adequately substantiated by the results of whatever constitutes a scientific test in those circumstances.

Scientific tests for claims of superiority in handling or vehicle handling characteristics shall include reliable measures to control the variable influences of the driver, road, and environment so that the contribution of the automobile or of a specific vehicle attribute, can be identified.

III.

It is further ordered, That for the purposes of Paragraph I of this Order, a statement about handling or any vehicle handling characteristic implies superiority if the statement is phrased in the comparative or superlative degree, or if any advertising containing such statement conveys a net impression of comparative superiority; *provided, however,* that any statement or statements in such advertising phrased in the comparative or superlative degree regarding any subject other than handling or vehicle handling characteristics will not, for that reason alone and without a statistically valid consumer survey, render any statement in such advertising which does relate to the handling or the vehicle handling characteristics of a vehicle and which is phrased in the positive degree to be deemed a representation that handling or vehicle handling characteristics of the vehicle are superior to any other vehicle or all other vehicles. A representation of superiority with respect to one or more specifically identified vehicle handling characteristics shall not give rise to any substantiation requirements with respect to any other vehicle handling characteristic.

IV.

It is further ordered, That respondent Campbell-Ewald Company shall forthwith distribute a copy of this Modified Order to each of its officers, agents, representatives, or employees who are engaged in the creation or approval of advertisements.

V.

It is further ordered, That respondent Campbell-Ewald Company notify the Commission at least thirty (30) days prior to any proposed change in said corporate respondent such as dissolution, assignment, or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change in the corporation which may affect compliance obligations arising out of this Modified Order.

VI.

It is further ordered, That respondent shall, within sixty (60) days after service upon it of this Modified Order, file with the Commission a report, in writing, setting forth in detail the manner and form in which it has complied with this Modified Order.

IN THE MATTER OF

THE ESTES PARK ACCOMMODATIONS ASSOCIATION, INC.

CONSENT ORDER IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket C-3143. Complaint, Aug. 21, 1984—Decision, Aug. 21, 1984

This consent order requires an association composed of operators of motels, hotels, cabins and campgrounds in the area of Estes Park, Colorado, to cease inhibiting competition by restricting, impeding or advising its members and others against the truthful advertising of the terms and conditions of their accommodations; and by declaring such activities unethical. The association is precluded from taking any action against a person charged with violating an ethical standard without first providing that person with reasonable notice of the allegations and a hearing, as well as written findings and conclusions concerning the allegations. Respondent must also remove from its membership application, policy statement or guidelines, any provision which is inconsistent with the prohibitions contained in the order.

Appearances

For the Commission: *Claude C. Wild, III.*

For the respondent: *R. Hallberg,* Estes Park, Col.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, as amended (15 U.S.C. 41 *et seq.*), and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that the named respondent has violated the provisions of Section 5 of the Federal Trade Commission Act and that a proceeding by it in respect thereof would be in the public interest, hereby issues this Complaint, stating its charges as follows:

PARAGRAPH 1. Respondent, The Estes Park Accommodations Association, Inc., is a corporation formed pursuant to the laws of the State of Colorado, with its mailing address at P.O. Box 178, Estes Park, Colorado.

PAR. 2. Respondent is an association formed to represent the interests of operators of motels, hotels, campgrounds, cabins, and other lodging facilities for travelers in the area of Estes Park, Colorado. Respondent has approximately 80 members, and these members control a substantial majority of the lodging facilities available to travelers in that area.

PAR. 3. Members of respondent are engaged in the business of providing lodging facilities to travelers for a profit. Except to the extent that competition has been restrained as herein alleged, members of respondent have been and are now in competition among themselves and with other operators of lodging facilities for travelers.

PAR. 4. Respondent is organized for the purpose, among others, of guarding and fostering the interests of its members. Respondent engages in activities which further its members' pecuniary interests. By virtue of its purposes and activities, respondent is a corporation within the meaning of Section 4 of the Federal Trade Commission Act, as amended, 15 U.S.C. 44.

PAR. 5. In the conduct of their business, members of respondent provide lodging facilities for travelers from other states and countries. Additionally, the respondent and its individual members send advertisements to recipients in other states, place advertisements in publications with interstate circulation, and participate in trade shows in other states. The acts and practices described below are "in or affecting commerce" within the meaning of Section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. 45(a)(1).

PAR. 6. Respondent has acted as a combination of at least some of its members or has conspired with at least some of its members to foreclose, frustrate, and eliminate competition among the operators of lodging facilities for travelers in the Estes Park, Colorado, area by:

A. Prohibiting its members from truthfully advertising their facilities and prices to the public, from distributing truthful information about their prices and facilities, and from otherwise soliciting travelers' business; and

B. Coercing individual members into abandoning their efforts to truthfully advertise their facilities, to distribute truthful information about their prices, and to otherwise solicit travelers' business.

PAR. 7. Respondent has engaged in various acts or practices in furtherance of this combination or conspiracy, including:

A. Adopting and implementing written and unwritten codes of ethics, policy statements and guidelines that prohibit efforts by its members to truthfully advertise the prices for their lodging facilities by means of posting price signs, or to otherwise distribute truthful information to the public about their facilities and prices;

B. Publishing statements by some of its officials advising members that certain advertising of prices is unethical and threatening expulsion and other sanctions against members that post price signs; and

C. Sending letters to individual members who truthfully advertised their facilities and prices that pressured such members to abandon such activities.

PAR. 8. Through the combination or conspiracy and the acts or practices described above, certain members of respondent have agreed not to, and do not, advertise or post the prices of their lodging facilities, and certain individual members of respondent have been coerced into abandoning the advertising of prices for their lodging facilities. Consequently, competition among the operators of lodging facilities for customers has been foreclosed, frustrated and eliminated, and customers have been deprived of the benefits of competition among the operators of lodging facilities.

PAR. 9. The combination or conspiracy and the acts and practices described above constitute unfair methods of competition or unfair or deceptive acts or practices in violation of Section 5 of the Federal Trade Commission Act. Such combination or conspiracy is continuing and will continue absent the entry against respondent of appropriate relief.

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of complaint which the Denver Regional Office proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Federal Trade Commission Act; and

The respondent, its attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provision as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondent has violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent The Estes Park Accommodations Association, Inc., is a corporation organized, existing and doing business under and by

virtue of the laws of the State of Colorado, with its mailing address at P.O. Box 178, Estes Park, Colorado.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

I.

For purposes of this Order, the following definitions shall apply:

A. *EPAA* means The Estes Park Accommodations Association, Inc., its members, officers, directors, committees, representatives, agents, employees, successors and assigns.

B. The term *lodging facilities* means motel rooms, hotel rooms, cottages, cabins and any other accommodations designed for the housing of travelers.

II.

It is ordered, That EPAA shall cease and desist from, directly or indirectly, or through any corporate or other device:

A. Restricting, regulating, impeding, declaring unethical, interfering with, or advising against the advertising, publishing, or posting by any person of the prices, terms, or conditions concerned with the furnishing of lodging facilities; and

B. Suggesting, inducing, urging, encouraging or assisting any person, business, or any other nongovernmental organization to take any of the actions prohibited by Part II (A).

Nothing contained in Part II shall prohibit EPAA from (1) filing any complaint with a governmental agency concerning violations of any law, or (2) formulating, adopting, disseminating to its members, and enforcing reasonable ethical guidelines governing the conduct of its members with respect to representations, including unsubstantiated representations, that would be false or deceptive within the meaning of Section 5 of the Federal Trade Commission Act.

III.

It is further ordered, That EPAA shall cease and desist from taking any action against a person alleged to have violated any ethical standard promulgated in conformity with this Order without first providing such person with:

A. Written notice of the allegations against him or her;

B. A hearing wherein such person, or a person retained by him or her, may seek to rebut such allegations; and

C. The written findings or conclusions of EPAA with respect to such allegations.

IV.

It is further ordered, That EPAA shall:

A. For a period of three years after service of the final Order, provide each new member of EPAA with a copy of the letter attached as Appendix A at the time the member is accepted into EPAA;

B. Within thirty (30) days after service of the final Order, send a copy of the letter attached as Appendix A to each current member of EPAA;

C. Within thirty (30) days after service of the final Order, remove from any existing EPAA membership application, policy statement, or guideline, any provision, interpretation, or policy statement which is inconsistent with Part II or Part III of this Order;

D. Within sixty (60) days after service of the final Order, file a written report with the Federal Trade Commission setting forth in detail the manner and form in which it has complied with this Order;

E. For a period of three (3) years after service of the final Order, maintain and make available to the Commission staff for inspection and copying, upon reasonable notice, records adequate to describe in detail any action taken in connection with the activities covered by Part II or Part III of this Order; and

F. Within one year after service of the final Order, and annually thereafter for a period of three (3) years, file a written report with the Federal Trade Commission setting forth in detail any action taken in connection with the activities covered by Part II or Part III of this Order.

V.

It is further ordered, That EPAA shall notify the Commission at least thirty (30) days prior to any proposed change in EPAA, such as dissolution, assignment, or sale resulting in the emergence of a successor corporation or association, or any other change in EPAA which may affect compliance obligations arising out of this Order.

APPENDIX A

[Letterhead of EPAA]

Dear Member:

The Estes Park Accommodations Association, Inc. (EPAA), and the Federal Trade Commission have entered into an agreement which resulted in an Order prohibiting EPAA or its members from:

1. Restricting, regulating, impeding, declaring unethical, interfering with, or advising against the advertising, publishing, or posting by any person of the prices, terms, or conditions concerned with the furnishing of lodging facilities; and

2. Suggesting, inducing, urging, encouraging or assisting any person, business, or any other nongovernmental organization to take any of the actions prohibited by the above paragraph.

The Order does not prohibit EPAA from:

1. Filing any complaint with a governmental agency concerning violations of any law, or

2. Formulating, adopting, disseminating to its members, and enforcing reasonable ethical guidelines governing the conduct of its members with respect to representations, including unsubstantiated representations, that would be false or deceptive within the meaning of Section 5 of the Federal Trade Commission Act.

EPAA may not take any action against a person alleged to have violated any ethical standard promulgated in conformity with this Order without providing such person with:

1. Written notice of the allegations against him or her;

2. A hearing wherein such person, or a person retained by him or her, may seek to rebut such allegations; and

3. The written findings or conclusions of EPAA with respect to such allegations.

A copy of the Complaint and Order issued pursuant to this agreement will be furnished by EPAA upon request.

Thank you for your cooperation.

Sincerely,

President
The Estes Park Accommodations
Association, Inc.

IN THE MATTER OF

THE AMERICAN COLLEGE OF OBSTETRICIANS AND GYNECOLOGISTS

MODIFYING ORDER IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT

Docket C-2855. Consent Order, Dec. 14, 1976—Modifying Order, Aug. 28, 1984

This Order reopens the proceeding and modifies the Consent Order entered against The American College of Obstetricians and Gynecologists ("ACOG"), 88 F.T.C. 955. Pursuant to ACOG's request, the Order has been modified by deleting Paragraph II(B), which barred the association from advising in favor of or against any relative value scale developed by third parties; and by inserting a provision identical to that contained in the Commission Order entered against *Michigan State Medical Society*, 101 F.T.C. 191. This provision allows ACOG more freedom to discuss any issue, including reimbursement, with third-party payers and governmental entities.

ORDER REOPENING AND MODIFYING FINAL ORDER

By petition filed May 2, 1984, the American College of Obstetricians and Gynecologists ("ACOG") asked the Commission to reopen and modify the Commission order in Docket No. C-2855 entered by consent against ACOG on December 14, 1976 ("Order") [88 F.T.C. 955]. ACOG requested that the Commission modify the Order by a) deleting Paragraph II(B) of the Order, which prohibits ACOG from advising in favor of or against any relative value scale developed by third parties (except that ACOG is permitted to provide historical data), and b) inserting a provision identical to a provision contained in the Commission's Order in *Michigan State Medical Society*, Docket No. 9129, 101 F.T.C. 191 (1983) ("*Michigan State*") that would allow ACOG more freedom to discuss issues relating to reimbursement with third-party payers and governmental entities. ACOG's petition was placed on the public record and no comments were received.

Upon consideration of ACOG's petition and other relevant information, the Commission finds that the public interest would be served by deleting Paragraph II(B) of the Order and by inserting the relevant provision contained in the order in *Michigan State*. ACOG has demonstrated that the Order's restriction on ACOG's ability to discuss relative value scales with third-party payers and governmental entities has caused injury to ACOG and the public that outweighs any benefit that may be derived from the restriction. Modification is also consistent with the Commission's decision in *Michigan State*.

The Order continues to prohibit ACOG from developing or circulating its own relative value guide for use by its members. In addition, although the Order no longer will prohibit ACOG from discussing relative value scales with governmental entities and third-party payers, serious antitrust concerns would arise were ACOG to negotiate or attempt to negotiate an agreement with any such party or engage in any type of coercive activity to effect such an agreement.

Accordingly,

It is ordered, That this matter be, and it hereby is, reopened and that the Order in Docket No. C-2855 be modified 1) to delete Paragraph II(B) and to redesignate Paragraphs II(C) and II(D) of the Order Paragraphs II(B) and II(C) respectively; 2) to renumber Paragraphs III, IV and V of the Order Paragraphs IV, V and VI respectively; and 3) to insert the following:

III.

It is further ordered, That this order shall not be construed to prevent ACOG from:

A. Exercising rights permitted under the First Amendment to the United States Constitution to petition any federal or state government, executive agency, or legislative body concerning legislation, rules or procedures, or to participate in any federal or state administrative or judicial proceeding.

B. Providing information or views, on its own behalf or on behalf of its members, to third-party payers concerning any issue, including reimbursement.

IN THE MATTER OF

SMITTY'S SUPER MARKETS, INC.

CONSENT ORDER, ETC. IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket 9172. Complaint, Dec. 16, 1983—Decision, Sept. 7, 1984

This consent order requires a Springfield, Missouri operator of retail grocery stores, among other things, to cease engaging in any concerted action to impede the collection or dissemination of comparative price information. For a period of five years, the company is prohibited from requiring price checkers to purchase items to be priced as a condition of allowing them to price check; denying price checkers the same access to its stores as is provided to customers; or coercing any price checker, publisher or broadcaster to refrain from collecting or reporting comparative price information. The company is also required to offer to reimburse TeleCable up to $1,000 for the broadcast of a comparative grocery price information program. Should the station elect to broadcast such a program, respondent is further required to post signs and place newspaper ads notifying the public that such a program is being broadcast.

Appearances

For the Commission: *Patricia Bremer.*

For the respondent: *Donald W. Jones,* Springfield, Mo.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, as amended, 15 U.S.C. 41 *et seq.,* and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that Smitty's Super Markets, Inc., Roswil, Inc., and David Porter (hereinafter sometimes referred to collectively as "respondents") have violated Section 5 of said Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues this complaint charging as follows:

1. Smitty's Super Markets, Inc., is a Missouri corporation with its principal offices at 218 South Glenstone, Springfield, Missouri.

2. Roswil, Inc., is a Missouri corporation trading and doing business as Ramey Super Markets. Its registered agent is Flavius Freeman, 1-130 Corporate Square, Springfield, Missouri.

3. David Porter is an individual trading and doing business as Porter's So-Lo Markets. Porter's business address is 1475 North National, Springfield, Missouri.

4. At all times relevant to this complaint, respondents have been engaged in the operation of retail grocery stores in Greene or Christian counties, Missouri (hereafter "Springfield"), said activities being in or affecting commerce as "commerce" is defined in the Federal Trade Commission Act.

5. Except to the extent that competition has been restrained as herein alleged, in the course and conduct of their retail grocery businesses respondents have been and are now in competition in or affecting commerce among themselves and with other corporations, firms, or individuals engaged in the operation of retail grocery stores in Springfield.

6. Vector Enterprises, Inc., (hereafter "Vector") has been and is engaged in the business of collecting and selling comparative retail grocery price information in various cities throughout the United States for publication or broadcast to consumers. This activity is sometimes referred to herein as "price checking."

7. On or about July 15, 1980, Vector began collecting comparative price information on a weekly basis at about five Springfield retail grocery stores, including stores of some of the respondents. Vector then began selling this comparative retail grocery price information to TeleCable of Springfield ("TeleCable"), a cable television operator in Springfield. TeleCable broadcast this information to cable television subscribers in Springfield. During the weeks immediately preceding October 14, 1981, Vector's price checking included stores operated by respondents and two other operators of retail grocery stores in Springfield.

8. Prior to October 14, 1981, each respondent agreed with one or more other respondents or other operators of retail grocery stores in Springfield to impede Vector's ability to price check. On or about that date, in furtherance of their agreements, each respondent and others took action that effectively prevented Vector from price checking in their stores.

9. As of October 14, 1981, as a direct result of the agreements alleged in Paragraph 8, and the actions taken in furtherance thereof, Vector was able to price check only one of the retail grocery chains that had been included in its survey. Thereafter, TeleCable broadcast the prices for just that one chain. On or about December 31, 1981, TeleCable stopped broadcasting Vector's price reporting program because Vector was no longer able to provide comparative price information for the major retail grocery chains in Springfield.

10. Through the acts and practices described above, each respondent has agreed, combined or conspired with one or more other respondents or other operators of retail grocery stores to prevent or obstruct the collection and dissemination of comparative grocery

price information, with the following actual or potential effects, among others:

a. Price competition among Springfield grocery retailers has been hindered or restrained; and

b. Consumers in Springfield have been deprived of comparative retail grocery price information that can be used in the selection of a grocery store.

11. The acts and practices described above constitute an unlawful restraint on price competition and constitute unfair methods of competition or unfair acts or practices. Respondents have violated Section 5(a)(1) of the Federal Trade Commission Act, as amended.

12. The acts and practices described above constitute an unlawful boycott and constitute unfair methods of competition or unfair acts or practices. Respondents have violated Section 5(a)(1) of the Federal Trade Commission Act, as amended.

13. The violations charged herein or the effects thereof are continuing and will continue in the absence of appropriate relief.

DECISION AND ORDER

The Commission having heretofore issued its complaint charging the respondent named in the caption hereof with violation of Section 5 of the Federal Trade Commission Act, as amended, and the respondent having been served with a copy of that complaint, together with a notice of contemplated relief; and

The respondent, its attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Secretary of the Commission having thereafter withdrawn this matter from adjudication as to this respondent in accordance with Section 3.25(c) of its Rules; and

The Commission having considered the matter and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, and having duly considered the comments filed thereafter by interested persons pursuant to Section 3.25 of its Rules, now in further conformity with the procedure prescribed in Section 3.25 of its Rules, the

Commission hereby makes the following jurisdictional findings and enters the following order:

1. Smitty's Super Markets, Inc., is a Missouri corporation, with its principal office at 218 South Glenstone, Springfield, Missouri.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

I.

For the purpose of this Order, the following definitions shall apply:

A. *Smitty's* means Smitty's Super Markets, Inc., its divisions and subsidiaries, officers, directors, representatives, agents, employees, successors and assigns.

B. *Price check* or *price checking* means the collecting, from information available to customers, of retail prices of items offered for sale by any retail grocery store (SIC 5411), which is done neither by nor on behalf of a person engaged in the sale of groceries, and which information is used in price reporting.

C. *Price checker* means any person engaged in price checking.

D. *Price reporting* or *price report* means the dissemination to the public of price checking information through any medium by any person not engaged in the sale of groceries.

E. *Springfield* means the counties of Christian and Greene, Missouri.

F. *Customer* means any individual who enters a retail grocery store for the purpose of grocery shopping, whether or not that individual actually makes a purchase.

G. *Person* means individuals, corporations, partnerships, unincorporated associations, and any other business entity.

H. *Geographic area* means: (1) a Standard Metropolitan Statistical Area as defined by the Bureau of the Census, U.S. Department of Commerce, as of October 1, 1982; or (2) a county.

I. *Supermarket* means any retail grocery store (SIC 5411) with annual sales of more than one million dollars ($1,000,000.00).

II.

It is further ordered, That:

A. Smitty's shall forthwith cease and desist from taking any action in concert with any other person engaged in the sale of grocery products which has the purpose or effect of restricting, impeding, interfering with or preventing price checking or price reporting.

B. Except as provided in paragraph II.C., for five (5) years following the date on which this Order becomes final, Smitty's shall cease and desist from taking or threatening to take any unilateral action that would:

1. Require price checkers to purchase items to be price checked as a condition of allowing them to price check; or

2. Deny price checkers the same access to Smitty's supermarkets as is provided to customers; or

3. Coerce, or attempt to coerce, any price checker, publisher or broadcaster into refraining from or discontinuing price checking or price reporting.

C. 1. Nothing in paragraph II.B. shall prevent Smitty's from adopting reasonable, non-discriminatory rules governing the number of price checkers in its supermarkets at any one time for the purpose of preventing disruption of Smitty's normal business operations.

2. Nothing in subparagraph II.B.3. shall prevent Smitty's from publicly commenting upon or objecting to any price report in which its prices are compared to those of any other grocery retailer.

3. Whenever Smitty's believes that conditions exist that justify the exclusion of a price checker, it may submit to the Federal Trade Commission a sworn statement setting forth with particularity the facts that Smitty's believes meet such conditions. For purposes of this Order, the only conditions justifying the exclusion of a price checker are that another supermarket operator with whose prices Smitty's prices are compared in a price report has knowingly tampered with or manipulated the results of such price report for its own competitive gain either (a) by the use of information wrongfully obtained and not available to all supermarket operators whose prices are being compared, or (b) by inducing any price reporter or price checker to cause false information to be published or broadcast. Following the Federal Trade Commission's actual receipt of such statement, Smitty's may exclude the price checkers from its supermarkets in the geographic area(s) covered by the affected price report for so long as the conditions set forth in Smitty's statement shall exist. In any civil penalty action against Smitty's for a violation of subparagraph II.B. 2. occurring after notice to the Federal Trade Commission was given by Smitty's as provided in this subparagraph, Smitty's shall have the burden of proving, by a preponderance of the evidence, that the conditions justifying the exclusion of a price checker as set forth in this subparagraph have been met. In meeting its burden, Smitty's may offer evi-

dence only for the purpose of proving the facts set forth in its statement to the Federal Trade Commission. Nothing in this subparagraph shall be construed to be an exception to the prohibitions of paragraph II.A. of this Order.

III.

It is further ordered, That, upon the resumption of price reporting by TeleCable of Springfield that is similar in quality and coverage to that broadcast by it prior to October 14, 1981, and that includes any Smitty's supermarket, and upon receipt by Smitty's of written request for payment from TeleCable, Smitty's shall reimburse TeleCable for its actual cost of obtaining a price reporting program up to the amount of two hundred fifty dollars ($250.00) per week. Smitty's obligation under this Part (III) shall terminate either when it has reimbursed TeleCable in the total amount of one thousand dollars ($1,000.00) or three (3) years following the date on which this Order becomes final, whichever occurs first. Smitty's shall not reimburse TeleCable for costs incurred by TeleCable during any week for which TeleCable's costs are reimbursed by any other person.

IV.

It is further ordered, That, within seven (7) days following the date on which this Order becomes final, Smitty's shall send a letter, a copy of which is attached here as Exhibit A, together with a copy of this Order, to TeleCable of Springfield, informing TeleCable of Smitty's obligations under Parts II and V of this Order, TeleCable's rights under Part III, and the notices that Smitty's must receive from TeleCable before certain Order provisions become binding upon Smitty's.

V.

It is further ordered, That, if at any time during the two years following the date on which this Order becomes final, Smitty's is notified in writing by TeleCable of Springfield that price reporting that includes any of Smitty's supermarkets has resumed in Springfield:

A. For a period of sixty (60) days following the receipt of such notice, Smitty's shall post signs no smaller than 30 inches by 40 inches in a front window in each of Smitty's supermarkets in Springfield, stating:

GROCERY PRICE SURVEY

A price survey comparing prices of selected grocery items at Smitty's and other Springfield grocery supermarkets is being broadcast over cable television. This comparative price survey can be seen on channel ________ and is broadcast from ________ to ________.

B. For a period of sixty (60) days following the receipt of such notice, whenever Smitty's places food advertisements of one-half page or larger in any printed advertising medium with circulation of 15,000 or more copies in Springfield, Smitty's shall publish an announcement as a part thereof in the same language provided in paragraph V.A. This announcement shall be no smaller than 3 inches high by 3 inches wide and shall be printed in conspicuous type. In each week in which Smitty's does not place a one-half page or larger food advertisement in such printed advertising medium, Smitty's shall place this announcement as a display advertisement in any printed advertising medium with circulation of 15,000 or more copies in Springfield.

VI.

It is further ordered, That Smitty's shall, within seven (7) days after the date on which this Order becomes final, and once a year thereafter for three years, provide a copy of this Order to each of its officers and supermarket managers, and secure from each such individual a signed statement acknowledging receipt of this Order.

VII.

It is further ordered, That Smitty's shall, within sixty (60) days after the date on which this Order becomes final, file with the Commission a verified written report, setting forth in detail the manner and form in which Smitty's has complied with this Order. Additional reports shall be filed at such other times as the Commission may by written notice require. Each compliance report shall include all information and documentation as may be required by the Commission to show compliance with this Order.

VIII.

It is further ordered, That Smitty's shall notify the Federal Trade Commission at least thirty (30) days prior to any proposed change in it such as dissolution, assignment or sale resulting in the emergence of a successor corporation, or any other proposed change in the corporation or its retail grocery operations, which may affect compliance obligations arising out of this Order.

EXHIBIT A

TeleCable of Springfield
1533 South Enterprise
Springfield, Missouri 65801

Dear Sir or Madam:

This is to notify you that Smitty's Super Markets, Inc. ("Smitty's"), which operates Smitty's grocery stores in Springfield, Missouri, has entered into a consent order with the Federal Trade Commission in which it has agreed that it will not interfere with efforts by independent parties such as TeleCable of Springfield to engage in price reporting or price checking in Smitty's grocery stores in Springfield. Smitty's has agreed that it will not require price checkers to purchase the items being price checked, will not deny price checkers the same access to its supermarkets as is provided to customers, and will not attempt to coerce any price checker, publisher or broadcaster into refraining from or discontinuing price checking or price reporting. The terms of and limitations on Smitty's agreement are set forth in a consent order issued by the Federal Trade Commission, a copy of which is enclosed herewith.

If TeleCable of Springfield institutes a price reporting program similar or superior in quality and coverage to the one broadcast by TeleCable in 1981, and if the program includes any of Smitty's grocery stores in Springfield, Missouri, Smitty's will reimburse TeleCable for its actual costs of obtaining price reports, up to the amount of $250 per week, and up to $1,000 in total. Smitty's will also place notices in its Springfield grocery stores and in its weekly advertisements, informing consumers of TeleCable's price surveys. The precise terms of Smitty's obligations to place such notices, and to reimburse TeleCable for certain of its costs, are set forth in the enclosed consent order.

In order to receive any funds to which you may be entitled and to effect the placement of the notices described above, please notify Smitty's in writing, c/o President, Smitty's Super Markets, Inc., 218 South Glenstone, Springfield, Missouri 65802, stating when the program began or is scheduled to begin, the time and channel on which the survey will be broadcast, and TeleCable's costs, if any, of obtaining the survey information.

Very truly yours,

President
Smitty's Super Markets, Inc.

IN THE MATTER OF

DAVID PORTER

CONSENT ORDER, ETC. IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket 9172. Complaint, Dec. 16, 1983—Decision, Sept. 7, 1984*

This consent order requires a Springfield, Missouri operator of retail grocery stores, among other things, to cease engaging in any concerted action to impede the collection or dissemination of comparative price information. For a period of five years, Mr. Porter is prohibited from requiring price checkers to purchase items to be priced as a condition of allowing them to price check; denying price checkers the same access to his stores as is provided to customers; or coercing any price checker, publisher or broadcaster to refrain from collecting or reporting comparative price information. Mr. Porter is also required, upon the resumption of price reporting by TeleCable of Springfield, to reimburse the company $250 per week for the cost of the program, up to $1,000, or for a period of three years, whichever comes first; and to notify consumers of the broadcast through posted signs and newspaper ads.

Appearances

For the Commission: *Patricia Bremer.*

For the respondent: *Donald W. Jones,* Springfield, Mo.

DECISION AND ORDER

The Commission having heretofore issued its complaint charging the respondent named in the caption hereof with violation of Section 5 of the Federal Trade Commission Act, as amended, and the respondent having been served with a copy of that complaint, together with a notice of contemplated relief; and

The respondent, his attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Secretary of the Commission having thereafter withdrawn this matter from adjudication as to this respondent in accordance with Section 3.25(c) of its Rules; and

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*Complaint previously published at 104 F.T.C. 526.

The Commission having considered the matter and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 3.25 of its Rules, the Commission hereby makes the following jurisdictional findings and enters the following order:

1. Respondent David Porter is an individual trading and doing business as Porter's So-Lo Markets, with his principal business office at 1475 North National, Springfield, Missouri.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

I.

For the purpose of this Order, the following definitions shall apply:

A. *Porter* means David Porter, individually and through Porter's So-Lo Markets or any other entity or corporate device, and his representatives, agents, employees, successors and assigns.

B. *Price check* or *price checking* means the collecting, from information available to customers, of retail prices of items offered for sale by any retail grocery store (SIC 5411), which is done neither by nor on behalf of a person engaged in the sale of groceries, and which information is used in price reporting.

C. *Price checker* means any person engaged in price checking.

D. *Price reporting* or *price report* means the dissemination to the public of price checking information through any medium by any person not engaged in the sale of groceries.

E. *Springfield* means the counties of Christian and Greene, Missouri.

F. *Customer* means any individual who enters a retail grocery store for the purpose of grocery shopping, whether or not that individual actually makes a purchase.

G. *Person* means individuals, corporations, partnerships, unincorporated associations, and any other business entity.

H. *Geographic area* means: (1) a Standard Metropolitan Statistical Area as defined by the Bureau of the Census, U.S. Department of Commerce, as of October 1, 1982; or (2) a county.

I. *Supermarket* means any retail grocery store (SIC 5411) with annual sales of more than one million dollars ($1,000,000.00).

II.

It is further ordered, That:

A. Porter shall forthwith cease and desist from taking any action in concert with any other person engaged in the sale of grocery products which has the purpose or effect of restricting, impeding, interfering with or preventing price checking or price reporting.

B. Except as provided in paragraph II.C., for five (5) years following the date on which this Order becomes final, Porter shall cease and desist from taking or threatening to take any unilateral action that would:

1. Require price checkers to purchase items to be price checked as a condition of allowing them to price check; or

2. Deny price checkers the same access to Porter's supermarkets as is provided to customers; or

3. Coerce, or attempt to coerce, any price checker, publisher or broadcaster into refraining from or discontinuing price checking or price reporting.

C. 1. Nothing in paragraph II.B. shall prevent Porter from adopting reasonable, non-discriminatory rules governing the number of price checkers in his supermarkets at any one time for the purpose of preventing disruption of Porter's normal business operations.

2. Nothing in subparagraph II.B.3. shall prevent Porter from publicly commenting upon or objecting to any price report in which his prices are compared to those of any other grocery retailer.

3. Whenever Porter believes that conditions exist that justify the exclusion of a price checker, he may submit to the Federal Trade Commission a sworn statement setting forth with particularity the facts that Porter believes meet such conditions. For purposes of this Order, the only conditions justifying the exclusion of a price checker are that another supermarket operator with whose prices Porter's prices are compared in a price report has knowingly tampered with or manipulated the results of such price report for its own competitive gain either (a) by the use of information wrongfully obtained and not available to all supermarket operators whose prices are being compared, or (b) by inducing any price reporter or price checker to cause false information to be published or broadcast. Following the Federal Trade Commission's actual receipt of such statement, Porter may exclude the price checkers from his supermarkets in the geographic area(s) covered by the affected price report for so long as the condi-

tions set forth in Porter's statement shall exist. In any civil penalty action against Porter for a violation of subparagraph II.B. 2. occurring after notice to the Federal Trade Commission was given by Porter as provided in this subparagraph, Porter shall have the burden of proving, by a preponderance of the evidence, that the conditions justifying the exclusion of a price checker as set forth in this subparagraph have been met. In meeting his burden, Porter may offer evidence only for the purpose of proving the facts set forth in his statement to the Federal Trade Commission. Nothing in this subparagraph shall be construed to be an exception to the prohibitions of paragraph II.A. of this Order.

III.

It is further ordered, That, upon the resumption of price reporting by TeleCable of Springfield that is similar in quality and coverage to that broadcast by it prior to October 14, 1981, and that includes any Porter supermarket, and upon receipt by Porter of written request for payment from TeleCable, Porter shall reimburse TeleCable for its actual cost of obtaining a price reporting program up to the amount of two hundred fifty dollars ($250.00) per week. Porter's obligation under this Part (III) shall terminate either when he has reimbursed TeleCable in the total amount of one thousand dollars ($1,000.00) or three (3) years following the date on which this Order becomes final, whichever occurs first. Porter shall not reimburse TeleCable for costs incurred by TeleCable during any week for which TeleCable's costs are reimbursed by any other person.

IV.

It is further ordered, That, within seven (7) days following the date on which this Order becomes final, Porter shall send a letter, a copy of which is attached here as Exhibit A, together with a copy of this Order, to TeleCable of Springfield, informing TeleCable of Porter's obligations under Parts II and V of this Order, TeleCable's rights under Part III, and the notices that Porter must receive from TeleCable before certain Order provisions become binding upon Porter.

V.

It is further ordered, That, if at any time during the two years following the date on which this Order becomes final, Porter is notified in writing by TeleCable of Springfield that price reporting that includes any of Porter's supermarkets has resumed in Springfield:

A. For a period of sixty (60) days following the receipt of such notice, Porter shall post signs no smaller than 30 inches by 40 inches in a front window in each of Porter's supermarkets in Springfield, stating:

GROCERY PRICE SURVEY

A price survey comparing prices of selected grocery items at Porter's So-Lo Markets and other Springfield grocery supermarkets is being broadcast over cable television. This comparative price survey can be seen on channel ________ and is broadcast from ________ to ________.

B. For a period of sixty (60) days following the receipt of such notice, whenever Porter places food advertisements of one-half page or larger in any printed advertising medium with circulation of 15,000 or more copies in Springfield, which advertisements cover only his own stores, Porter shall publish an announcement as a part thereof in the same language provided in paragraph V.A. This announcement shall be no smaller than 3 inches high by 3 inches wide and shall be printed in conspicuous type. In each week in which Porter does not place a one-half page or larger food advertisement in such printed advertising medium, Porter shall place this announcement as a display advertisement in any printed advertising medium with circulation of 15,000 or more copies in those areas of Springfield in which Porter's stores are located.

VI.

It is further ordered, That Porter shall, within seven (7) days after the date on which this Order becomes final, and once a year thereafter for three years, provide a copy of this Order to each of his supermarket managers, and secure from each such individual a signed statement acknowledging receipt of this Order.

VII.

It is further ordered, That Porter shall, within sixty (60) days after the date on which this Order becomes final, file with the Commission a verified written report, setting forth in detail the manner and form in which Porter has complied with this Order. Additional reports shall be filed at such other times as the Commission may by written notice require. Each compliance report shall include all information and documentation as may be required by the Commission to show compliance with this Order.

VIII.

It is further ordered, That Porter shall notify the Federal Trade Commission at least thirty (30) days prior to the discontinuance of his present business or employment as an individual proprietorship in the sale of groceries, or at least thirty (30) days prior to his affiliation with a new business or employment, or of any similar change which may affect compliance obligations arising out of this Order. The notice provision of this Part shall include any change in the organizational status of Porter's present business, such as incorporation, assignment or sale, resulting in the emergence of a successor entity, or any other change in Porter's business or his retail grocery operations.

EXHIBIT A

TeleCable of Springfield
1533 South Enterprise
Springfield, Missouri 65801

Dear Sir or Madam:

This is to notify you that I, David Porter, the owner of Porter's So-Lo Markets in Springfield, Missouri, have entered into a consent order with the Federal Trade Commission in which I have agreed that I will not interfere with efforts by independent parties such as TeleCable of Springfield to engage in price reporting or price checking in my grocery stores in Springfield. I have agreed that I will not require price checkers to purchase the items being price checked, will not deny price checkers the same access to my supermarkets as is provided to customers, and will not attempt to coerce any price checker, publisher or broadcaster into refraining from or discontinuing price checking or price reporting. The terms of and limitations of the agreement are set forth in a consent order issued by the Federal Trade Commission, a copy of which is enclosed herewith.

If TeleCable of Springfield institutes a price reporting program similar or superior in quality and coverage to the one broadcast by TeleCable in 1981, and if the program includes any of my grocery stores in Springfield, Missouri, I will reimburse TeleCable for its actual costs of obtaining price reports, up to the amount of $250 per week, and up to $1,000 in total. I will also place notices in my Springfield grocery stores and in weekly advertisements, informing consumers of TeleCable's price surveys. The precise terms of my obligations to place such notices, and to reimburse TeleCable for certain of its costs, are set forth in the enclosed consent order.

In order to receive any funds to which you may be entitled and to effect the placement of the notices described above, please notify me in writing, c/o Porter's So-Lo Markets, 1475 North National, Springfield, Missouri 65802, stating when the program began or is scheduled to begin, the time and channel on which the survey will be broadcast, and TeleCable's costs, if any, of obtaining the survey information.

Very truly yours,

David Porter

IN THE MATTER OF

ARMSTRONG CORK COMPANY

MODIFYING ORDER, ETC., IN REGARD TO ALLEDED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 2(a) OF THE CLAYTON ACT

Docket C-1010. Consent Order, Nov. 3, 1965—Modifying Order, Sept. 10, 1984

This Order reopens the proceeding and modifies an FTC Consent Order issued on November 3, 1965, 68 F.T.C. 849, which alleged that a manufacturer and distributor of floor-covering products had conspired with its wholesalers to reduce competition by fixing resale prices and conditions of product sale to retailers and flooring contractors, and by discriminating in price between competing buyers. After considering company petitions, supporting materials and other relevant information, the Commission concluded that hardships to the company and the public outweighed any benefit derived from the prohibition against imposing "terms or conditions" on resale of products, and deleted the language "terms or conditions" from paragraphs 1, 2, and 4 of Part I of the Order. The Commission also deleted the word "rebates" from paragraph 2 after finding that such modification would also be in the public interest since it would permit the company to funnel "direct-to-consumer" rebates through its wholesalers and retailers. However, the Commission declined to set or modify other parts of the Order, holding that the firm had failed to demonstrate any change of law, fact, or public interest consideration that would justify further modification.

ORDER REOPENING AND MODIFYING FINAL ORDER

By petition of October 21, 1983, as supplemented and refiled on February 28, 1984, Armstrong World Industries, Inc. (formerly Armstrong Cork Company and hereinafter "Armstrong") asked the Commission to reopen and modify the Commission order issued against Armstrong on November 3, 1965. Armstrong requested that the Commission (1) modify Part I of the order by (a) deleting provisions prohibiting certain non-price vertical restraints; and (b) limiting the geographic scope of the resale price maintenance prohibitions; (2) set aside Parts II and III of the order; (3) set aside or modify Part IV of the order; and (4) substitute "Armstrong World Industries, Inc." for "Armstrong Cork Company" as the respondent to the order. Armstrong's October 21, 1983 and February 28, 1984 submissions were placed on the public record and no comments were received.

Upon consideration of Armstrong's petition and supporting materials, and other relevant information, the Commission finds that a modification of the order to delete the words "terms or conditions" from paragraphs 1, 2, and 4 of Part I is in the public interest. Armstrong has sufficiently demonstrated that the prohibition against Armstrong's imposing any terms or conditions on the resale of its

Modifying Order

products by Armstrong's customers has caused hardships to Armstrong and the public that outweigh any benefits that may be derived from the prohibition. The "terms or conditions" language of the order, which was intended to reach only price terms, not non-price restraints, was overly broad in this case. Thus, modification of the order to delete the words "terms or conditions" is both in the public interest and consistent with the treatment of non-price vertical restraints in *Continental T.V. Inc. v. GTE-Sylvania, Inc.*, 433 U.S. 36 (1977).

The Commission also finds that deletion of the term "rebates" from paragraph 2 of Part I of the order is in the public interest. Armstrong states that it views the presence of the term "rebates" in that paragraph as prohibiting it from funnelling "direct-to-consumer" rebates through wholesalers and retailers. Armstrong has demonstrated that permitting it to offer rebates in this manner will benefit both Armstrong and consumers. And, permitting Armstrong to funnel "direct-to-consumer" rebates through wholesalers and retailers should not affect the wholesalers' and retailers' ability to independently determine the resale price of the product. Moreover, if Armstrong should use the rebates to engage in resale price maintenance, it would violate the order provisions prohibiting resale price fixing. Thus, because deleting "rebates" from paragraph 2 of Part I of the order should benefit both Armstrong and consumers without permitting resale price maintenance, granting Armstrong's requested modification is in the public interest.

However, the Commission has denied Armstrong's request to set aside paragraph 3 of Part I of the order. That paragraph is an integral part of the order's prohibition of resale price maintenance and Armstrong has demonstrated no change of law or fact or public interest considerations sufficient to require setting it aside.

The Commission has also declined to set aside paragraph 5 of Part I of the order. That paragraph does not require Armstrong to incur the costs it states it has incurred in fashioning a program to comply with the order. Nor does the order prohibit wholesalers from supplying inventory information in the least costly fashion possible. Rather the order simply prohibits Armstrong from *requiring* or *requesting* purchasers of its products to supply Armstrong with information concerning the resale prices charged by these purchasers. On the other hand, permitting Armstrong to request or require its purchasers of Armstrong's products to provide reports showing the prices at which they resell these products could affect its purchasers' pricing practices because they could view such reports as a means of monitoring their pricing. Thus, the benefits of this provision outweigh its *de minimis* costs, particularly when the order does not *require* either Armstrong or its customers to incur such costs.

Additionally, the Commission has refused Armstrong's request to limit the geographic scope of the order's resale price maintenance provisions to "within the United States." The Foreign Trade Antitrust Improvements Act of 1982, which clarified the extraterritorial application of domestic antitrust laws and the Federal Trade Commission Act, substantially addressed the concerns expressed by Armstrong in its petition. Moreover, Armstrong has failed to demonstrate any need to impose a limitation on the extraterritorial application of the order beyond that provided by statute.

The Commission also has found it unnecessary to set aside Parts II and III of the order. By their terms these provisions impose no prospective obligations on Armstrong.

Armstrong also asked the Commission to set aside or modify Part IV of the order, but the Commission has declined to do so because Armstrong has not demonstrated a change of law or fact or public interest considerations sufficient to require setting aside or modifying that Part. Part IV of the order only requires that Armstrong treat competing customers equally or be able to justify any differences in treatment by means of one of the statutory defenses or the defense applicable to sales to the United States government. *See Federal Trade Commission v. Ruberoid Co.,* 343 U.S. 470 (1952). Thus, the Commission sees no need to set aside or limit the term of Part IV. Moreover, if Armstrong is uncertain whether a proposed course of conduct would violate Part IV of the order, Armstrong may ask the Commission for an advisory opinion under Section 2.41 of the Commission's Rules, 16 C.F.R. 2.41 (1984).

Finally, Armstrong asked that the order be modified to substitute "Armstrong World Industries, Inc." for "Armstrong Cork Company" as the respondent to the order. The Commission finds that this modification is unnecessary because the order expressly binds the successors and assigns of Armstrong Cork Company and Armstrong's request therefore is denied.

Accordingly,

It is ordered, That this matter be reopened and that paragraphs 1, 2, and 4 of Part I of the order in Docket No. C-1010 be modified, as of the date of service of this order. Those paragraphs will now provide:

1. Engaging in, participating in, continuing, carrying out or enforcing any contract, agreement, arrangement or understanding, with any wholesalers, distributors, or other purchasers of Armstrong floor covering products, which directly or indirectly establishes, maintains or fixes prices of resale of such products by such wholesalers, distributors, or other purchasers.

2. Enforcing, or attempting to enforce the price or prices or suggest-

ed prices or discounts for the resale of Armstrong floor covering products.

* * * * * * *

4. Circulating to or exchanging with any wholesaler or distributor or other purchaser, any circulars, price lists, suggested price lists, policy letters or other information, the effect of which is to create a contract, agreement, arrangement, or understanding which fixes or establishes a price or prices at or upon which any Armstrong floor covering products shall be resold.

IN THE MATTER OF

WILLIAM H. RORER, INC.

MODIFYING ORDER IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 2(a) OF THE CLAYTON ACT

Docket 8599. Final Order, Aug. 21, 1967—Modifying Order, Sept. 14, 1984

This Order modifies the August 21, 1967 Order issued against a pharmaceutical manufacturer, 72 F.T.C. 412, pursuant to the March 20, 1967 decision of the Court of Appeals for the Second Circuit, 374 F.2d 622 (1967). After reviewing respondent's request and other relevant information, the Commission denied the request to vacate the Order in its entirety and retained the provision that prohibited the company from charging different prices for its products to competing customers. The Commission noted that the Order "in essence requires compliance with Section 2(a) of the Robinson-Patman Act," and the firm had not shown that complying with an order that essentially requires adherence to the law is causing it injury. However, the Commission determined that retaining certain "fencing-in" provisions that had been in effect for 17 years "placed the firm at a disadvantage with respect to its competitors by increasing its compliance costs unnecessarily." Therefore, in accordance with its conclusions, the Commission modified the Order by deleting requirements that the company promptly inform the Commission when it charged competing retailers different prices for its products, submit to the Commission a written statement containing justification for price differences, and publicize to all its retail customers that prices to some are higher than to others, together with reasons and details of the price differences or discounts.

ORDER MODIFYING CEASE AND DESIST ORDER ISSUED AUGUST 21, 1967

On March 2, 1984, respondent William H. Rorer, Inc. ("Rorer") filed a "Request To Reopen Proceeding And Vacate Cease And Desist Order" ("Request"), pursuant to Section 5(b) of the Federal Trade Commission Act, 15 U.S.C. 45(b) and Section 2.51 of the Commission's Rules of Practice. The Request asked the Commission to reopen the proceeding and vacate the cease and desist order issued on August 21, 1967 ("the Order") in its entirety.

After reviewing respondent's Request and other relevant information, the Commission has concluded that respondent has not made a satisfactory showing that changed conditions of law or fact or public interest considerations require that the Order be vacated in its entirety. The Commission has found, however, that it is in the public interest to modify the Order to terminate certain of its provisions.

The Order against Rorer prohibits price discrimination in the sale of prescription and nonprescription pharmaceutical products and in essence requires compliance with Section 2(a) of the Robinson-Patman Act. Additionally, the Order contains certain provisions designed to help ensure compliance with the prohibition of price discrimination. The Commission finds that the changed facts relied on by Rorer do not provide a basis for setting aside the Order. Rorer maintains that the nature of the marketplace for antacids has changed since the Order was issued. In particular, Rorer says that independent drug stores are less significant outlets for its products than they were at the time the Order issued. However, Rorer has failed to show that independent drugstores or other retailers would not suffer competitive injury from illegal price discrimination favoring their competitors. Moreover, such changes do not warrant setting aside an order that applies to all competing retailers, not merely to independent drugstores. Indeed, the growing importance of mass marketers in the sale of covered products cited by Rorer demonstrates that it was appropriate for the Commission to issue, and for the Court of Appeals to sustain, an order applicable to all competing retailers.

Further, the Order's requirement that Rorer comply with the law in its sales of all of its "prescription and nonprescription pharmaceutical products" does not justify reopening of the Order. The fact that Rorer has introduced new products since the Order was issued and that the percentage of total Rorer sales accounted for by Maalox (the product involved in the original case) has declined are not reasons for setting aside the Order. Rorer has not shown that complying with an order that essentially requires adherence to the law is causing it injury.

Rorer also says that legal and economic thinking about the Robinson-Patman Act has changed since the Order was issued and that the level of Commission enforcement activity has declined. Request, pp. 27–29. Rorer does not contend, however, that the conduct that led to the Order would be legal today. Indeed, the Second Circuit found that the discrimination in this case, which continued for eight years, constituted a serious and extensive violation and amounted to "a classic price discrimination in favor of the chains as against individual retailers, a principal reason for and target of the Robinson-Patman Act." 374 F.2d 622, at 625 (2d Cir. 1967).

Nor has Rorer demonstrated that there has been a change in law or policy regarding the duration of conduct orders issued by the Commission. As a general rule, the Commission has issued perpetual orders in conduct cases and the perpetual conduct order is an important element of the Commission's ability to deter law violations. The deterrent effect of law enforcement actions by the Commission could be adversely affected if the Commission were to sunset conduct orders that do no more than require compliance with the law. And in recent cases the Commission has declined to terminate conduct orders solely because of their age. *See, e.g., National Dairy Products Corp.,* 100

F.T.C. 431 (1982) (Commission declined either to rescind or terminate in five years a perpetual order issued under Section 2(a) of the Clayton Act); *ABC Vending Corp.*, Docket No. 7652 (Letter from Secretary of the Commission to Arthur H. Kahn, Esquire, dated January 28, 1982, declining to set aside perpetual order provision based on Section 2(f) of the Clayton Act that "merely restates the law that must be adhered to by the respondent . . . and consequently does not hinder the respondent's ability to compete"); Letter of April 11, 1984 from Secretary of the Commission to James T. Halverson, Esq. concerning the Beecham Petition (Docket Nos. 8547, C-2037, C-2266 and Docket No. 4332); *Textileather Corp.*, Docket No. 1585 (Letter of January 20, 1984 from Secretary of the Commission to Kenneth B. Peterson, Esq.).[1]

Rorer has also failed to show that it would be in the public interest to terminate the Order. Rorer's arguments that the Order prevents it from competing misconstrue the scope and meaning of the Order in two important respects. First, Rorer claims in effect that the Order bars *all* price discrimination among competing retailers that is not concurrently cost justified to the Commission. Request, p. 37. This, however, is not the case. The Order does not bar all price discrimination, although it does require certain compliance procedures regarding discriminations in price that are allegedly justified by savings in costs. Second, Rorer says that no "meeting competition" defense is included in the Order. Request, pp. 38-39. While it is true that the defense is not explicitly stated in the Order, the Supreme Court held in *FTC v. Ruberoid Co.*, 343 U.S. 470 (1952), that the cost justification and meeting competition defenses "are necessarily implicit in every order issued under the authority of the act just as if the order set them out *in extenso*." 343 U.S. at 476. Thus, the order does not prohibit Rorer from granting price discounts either in instances where it can cost justify those discounts or where it is meeting the lawful competition of a competitor.

However, the Commission has determined that the public interest warrants modifying the Order to terminate certain "fencing-in" provisions. These provisions require that in any instance where respondent institutes a price schedule charging a different price for its products to competing retail customers "on the basis or in the belief" that such difference in price is cost justified (1) it promptly notify the Commission of the institution of such price schedule; (2) submit to the Commission a written statement with necessary underlying data in support of the cost justification of such price discrimination; and (3) adequately and regularly publicize to all retail customers that prices to some are higher than to others, together with reasons and details of the price differences or discounts. These "fencing-in" provisions have now been in effect for almost 17 years. The Commission finds that the pattern of conduct by Rorer which led to the entry of these "fencing-in" provisions has now been interrupted for a sufficient period of time so that they are no longer necessary either to dissipate the effects of respondent's past conduct or to prevent its recurrence. Although these provisions were justified at the time the Order was issued, their continued existence puts respondent at a disadvantage with respect to its competitors by increasing its compliance costs unnecessarily.

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[1] In *Occidental Petroleum Corp.*, Docket No. C-2492, the Commission terminated a perpetual reciprocity order after the expiration of ten years. However, *Occidental* involved a broad order, issued under Section 5 of the Federal Trade Commission Act, that prohibited all forms of reciprocity including practices that are today considered lawful and procompetitive. In contrast to the broad reach of Section 5, the Robinson-Patman Act is far more specific in defining prohibited forms of conduct.

Accordingly, *it is ordered* that this matter be, and it hereby is, reopened, and that the Commission's Order issued on August 21, 1967, be, and it hereby is, modified to read as follows:

It is ordered, That respondent William H. Rorer, Inc., a corporation, and its officers, representatives, agents and employees, directly, indirectly, or through any corporate or other device, in or in connection with the sale of prescription and nonprescription pharmaceutical products in commerce, as "commerce" is defined in the amended Clayton Act, do forthwith cease and desist from discriminating, directly or indirectly, in the price of such products of like grade and quality by selling to some retailers at prices higher than the price charged to any other retailer who, in fact, competes in the resale and distribution of respondent's products with the retailer paying the higher prices.

IN THE MATTER OF

FOREMOST DAIRIES, INC.

Docket C-1161. Consent Order, Jan. 23, 1967—Set Aside Order, Sept. 18, 1984

This Order reopens the proceeding and sets aside the divestiture Order issued against a dairy products processor in 1967 (71 F.T.C. 56) and modified in 1983 (101 F.T.C. 343) by deleting the provision requiring prior Commission approval for any further acquisitions by the company. After considering the request of successor company, McKesson Corporation, together with supporting materials and other relevant data, the Commission found that the competitive problem that had prompted issuance of the divestiture Order no longer existed and termination of the Order to relieve respondent of compliance costs was in the public interest.

ORDER REOPENING AND SETTING ASIDE MODIFIED ORDER ISSUED ON JANUARY 23, 1967

By a petition filed on May 16, 1984, and a supplement thereto dated June 29, 1984, McKesson Corporation (formerly Foremost-McKesson, Inc. and Foremost Dairies, Inc. and hereafter "McKesson") requests that the Commission reopen the proceeding in Docket No. C-1161 and set aside the modified order against McKesson issued by the Commission on January 23, 1967. Pursuant to Section 2.51 of the Commission's Rules of Practice, McKesson's petition was placed on the public record for comment. No comments were received.

Upon consideration of McKesson's petition and supporting materials, and other relevant information, the Commission now finds that changed conditions of fact and the public interest warrant reopening the proceeding and setting aside the modified order. The record demonstrates that the competitive problem Paragraph IV of the order intended to remedy no longer exists and termination of the order to relieve respondent of compliance costs is in the public interest.

Accordingly,

It is ordered, That this matter be, and it hereby is reopened and that the Commission's modified order be, and it is hereby set aside.

Chairman Miller did not participate.

IN THE MATTER OF

SPERRY CORPORATION,
DKG ADVERTISING, INC.,
NORTH AMERICAN PHILIPS CORPORATION
and
MCCAFFREY AND MCCALL, INC.

Dockets C-3068, C-3069, C-3105 & C-3106. Interlocutory Orders, Sept. 21, 1984

In four separate Orders Terminating Show Cause Proceeding, the FTC declined to modify the "reasonable" provision in individual consent orders issued against two manufacturers of electric shavers for black men, and their advertising agencies. This provision barred the companies from claiming, without a reasonable basis consisting of two well-controlled clinical studies, that their products reduced or alleviated "razor bumps," a skin condition affecting many black men. The Commission asserted that while its Show Cause Orders had solicited from the four companies and other interested parties evidence that one well-controlled clinical study would satisfy the "reasonable basis" requirement and serve the public interest, lesser substantiation was not warranted in this case. The Commission's review of the entire record, including public comment and complaint counsel's memoranda, together with the alleged improper conduct of respondents in the past, indicated that the "reasonable basis" requirement of two well-controlled clinical tests should not be modified.

ORDER TERMINATING SHOW CAUSE PROCEEDING

On March 8, 1983, the Federal Trade Commission issued a Show Cause Order instructing respondent Sperry Corporation to show cause, if any, why a Decision and Order issued against the company on July 17, 1981 [98 F.T.C. 4], should not be reopened and modified. The July 17, 1981, cease and desist order prohibited Sperry Corporation from claiming that the Black Man's Shaver or any other product reduces or treats a painful medical condition known as pseudofolliculitis barbae (or "razor bumps") unless the company possesses and relies on a reasonable basis consisting of two well-controlled clinical studies. In its Show Cause Order the Commission solicited evidence from respondent and any other interested party as to whether one well-controlled clinical study would satisfy the reasonable basis requirement contained in the order and as to whether it would be in the public interest to replace the existing two clinicals requirement with a one clinical test requirement.

Our review of the entire record of this proceeding, including the eight public comments received and complaint counsel's extensive memorandum, leads us to conclude that, although a different level of substantiation might be appropriate in other circumstances, two clinical studies represent the appropriate level of substantiation that should be required in this order. In arriving at this conclusion we have, among other things, weighed the benefits of having two well-designed tests, such as increased certainty that claims based on the tests are accurate, against the costs saved by requiring only one such test. The significance of these factors varies from case to case. Here, the benefits are self-evident and substantial. Requiring two tests will significantly reduce the risk that the respondent will disseminate inaccurate claims concerning a product that not only fails to treat a serious and painful medical condition as advertised but may actually prolong or exacerbate the condition. In contrast, savings the company might achieve by conducting one fewer test appear modest since the relatively low cost of conducting a second test would not greatly exceed the cost of a single test that included additional procedural safeguards needed to enhance its reliability, such as those proposed by complaint counsel and the experts who commented. Finally, respondent's past conduct, as alleged in the complaint, of making false and unsubstantiated claims for its product on the basis of inadequate and flawed testing warrants imposition of a more rigorous substantiation requirement to provide additional assurance that the respondent will not engage in such conduct in the future.

For these reasons, we are unpersuaded that the public interest would be served by a reduction in the level of substantiation required under this order. We therefore direct that the show cause proceeding instituted on March 8, 1983, be terminated and that no modification be made to the Decision and Order issued against Sperry Corporation on July 17, 1981.

ORDER TERMINATING SHOW CAUSE PROCEEDING

On March 8, 1983, the Federal Trade Commission issued a Show Cause Order instructing respondent DKG Advertising, Inc. to show cause, if any, why a Decision and Order issued against the company on July 17, 1981 [98 F.T.C. 15], should not be reopened and modified. The July 17, 1981, cease and desist order prohibited DKG Advertising, Inc. from claiming that the Black Man's Shaver or any other product reduces or treats a painful medical condition known as pseudofolliculitis barbae (or "razor bumps") unless the company possesses and relies on a reasonable basis consisting of two well-controlled clinical studies. In its Show Cause Order the Commission solicited evidence from respondent and any other interested party as to whether one well-controlled clinical study would satisfy the reasonable basis requirement contained in the order and as to whether it would be in the public interest to replace the existing two clinicals requirement with a one clinical test requirement.

Our review of the entire record of this proceeding, including the eight public comments received and complaint counsel's extensive memorandum, leads us to conclude that, although a different level of substantiation might be appropriate in other circumstances, two clinical studies represent the appropriate level of substantiation that should be required in this order. In arriving at this conclusion we have, among other things, weighed the benefits of having two well-designed tests, such as increased certainty that claims based on the tests are accurate, against the costs saved by requiring only one such test. The significance of these factors varies from case to case. Here, the benefits are self-evident and substantial. Requiring two tests will significantly reduce the risk that the respondent will disseminate inaccurate claims concerning a product that not only fails to treat a serious and painful medical condition as advertised but may actually prolong or exacerbate the condition. In contrast, the savings the company might achieve by conducting one fewer test appear modest since the relatively low cost of conducting a second test would not greatly exceed the cost of a single test that included additional procedural safeguards needed to enhance its reliability, such as those proposed by complaint counsel and the experts who commented. Finally, respondent's past conduct, as alleged in the complaint, of making false and unsubstantiated claims for its product on the basis of inadequate and flawed testing warrants imposition of a more rigorous substantiation requirement to provide additional assurance that the respondent will not engage in such conduct in the future.

For these reasons, we are unpersuaded that the public interest would be served by a reduction in the level of substantiation required under this order. We therefore direct that the show cause proceeding instituted on March 8, 1983, be terminated and that no modification be made to the Decision and Order issued against DKG Advertising, Inc. on July 17, 1981.

ORDER TERMINATING SHOW CAUSE PROCEEDING

On March 8, 1983, the Federal Trade Commission issued a Show Cause Order instructing respondent North American Philips Corporation to show cause, if any, why a Decision and Order issued against the company on March 7, 1983 [101 F.T.C. 359], should not be reopened and modified. The March 7, 1983, cease and desist order prohibited North American Philips Corporation from claiming that the Black Pro shaver or any other electric shaver, drug, or device reduces or treats a painful medical condition known as pseudofolliculitis barbae (or "razor bumps") unless the company possesses and relies on a reasonable basis consisting of two well-controlled clinical studies. In its Show Cause Order the Commission solicited evidence from respondent and any other interested party as to whether one well-controlled clinical study would satisfy the reasonable basis requirement contained in the order and as to whether it would be in the public interest to replace the existing two clinicals requirement with a one clinical test requirement.

Our review of the entire record of this proceeding, including the eight public comments received and complaint counsel's extensive memorandum, leads us to conclude that, although a different level of substantiation might be appropriate in other circumstances, two clinical studies represent the appropriate level of substantiation that should be required in this order. In arriving at this conclusion we have, among other things, weighed the benefits of having two well-designed tests, such as increased certainty that claims based on the tests are accurate, against the costs saved by requiring only one such test. The significance of these factors varies from case to case. Here, the benefits are self-evident and substantial. Requiring two tests will significantly reduce the risk that the respondent will disseminate inaccurate claims concerning a product that not only fails to treat a serious and painful medical condition as advertised but may actually prolong or exacerbate the condition. In contrast, savings the company might achieve by conducting one fewer test appear modest since the relatively low cost of conducting a second test would not greatly exceed the cost of a single test that included additional procedural safeguards needed to enhance its reliability, such as those proposed by complaint counsel and the experts who commented. Finally, respondent's past conduct, as alleged in the complaint, of making false and unsubstantiated claims for its product on the basis of inadequate and flawed testing warrants imposition of a more rigorous substantiation requirement to provide additional assurance that the respondent will not engage in such conduct in the future.

For these reasons, we are unpersuaded that the public interest would be served by a reduction in the level of substantiation required under this order. We therefore direct that the show cause proceeding instituted on March 8, 1983, be terminated and that no modification be made to the Decision and Order issued against North American Philips Corporation on March 7, 1983.

ORDER TERMINATING SHOW CAUSE PROCEEDING

On March 8, 1983, the Federal Trade Commission issued a Show Cause Order instructing respondent McCaffrey and McCall, Inc. to show cause, if any, why a Decision and Order issued against the company on March 7, 1983 [101 F.T.C. 367], should not be reopened and modified. The March 7, 1983, cease and desist order prohibited McCaffrey and McCall, Inc. from claiming that the Black Pro shaver or any other electric shaver, drug, or device reduces or treats a painful medical condition known as pseudofolliculitis barbae (or "razor bumps") unless the company possesses and relies on a reasonable basis consisting of two well-controlled clinical studies. In its Show Cause Order the Commission solicited evidence from respondent and any other interested party as to whether one well-controlled clinical study would satisfy the reasonable basis requirement contained in the order and as to whether it would be in the public interest to replace the existing two clinicals requirement with a one clinical test requirement.

Our review of the entire record of this proceeding, including the eight public comments received and complaint counsel's extensive memorandum, leads us to conclude that, although a different level of substantiation might be appropriate in other circumstances, two clinical studies represent the appropriate level of substantiation that should be required in this order. In arriving at this conclusion we have, among other things, weighed the benefits of having two well-designed tests, such as increased certainty that claims based on the tests are accurate, against the costs saved by requiring only one such test. The significance of these factors varies from case to case. Here, the benefits are self-evident and substantial. Requiring two tests will significantly reduce the risk that the respondent will disseminate inaccurate claims concerning a product that not only fails to treat a serious and painful medical condition as advertised but may actually prolong or exacerbate the condition. In contrast, savings the company might achieve by conducting one fewer test appear modest since the relatively low cost of conducting a second test would not greatly exceed the cost of a single test that included additional procedural safeguards needed to enhance its reliability, such as those proposed by complaint counsel and the experts who commented. Finally, respondent's past conduct, as alleged in the complaint, of making false and unsubstantiated claims for its product on the basis of inadequate and flawed testing warrants imposition of a more rigorous substantiation requirement to provide additional assurance that the respondent will not engage in such conduct in the future.

For these reasons, we are unpersuaded that the public interest would be served by a reduction in the level of substantiation required under this order. We therefore direct that the show cause proceeding instituted on March 8, 1983, be terminated and that no modification be made to the Decision and Order issued against McCaffrey and McCall, Inc. on March 7, 1983.

IN THE MATTER OF

MATTEL, INC.

and

CARSON-ROBERTS, INC.

Dockets C-2071 & C-2072. Consent Orders, Nov. 1, 1971—
Modifying Order, Sept. 24, 1984

In response to a joint petition from a toy manufacturer and its advertising agency, this Order reopens the proceedings and modifies Paragraph One of two 1971 consent orders issued against Mattel, Inc., 79 F.T.C. 667, and Carson-Roberts, Inc. (succeeded by Ogilvy & Mather U.S., a Division of Ogilvy & Mather International Inc.), 79 F.T.C. 674. Noting that Paragraph One of the Orders prohibited the use of certain film or camera techniques in children's advertising only if they misrepresented advertised product's performance, operation or use, the Commission held that modification clarifying the circumstances under which these techniques may be used would be in the public interest. The Commission therefore added a proviso permitting the non-deceptive use of the techniques if respondents possessed and relied on competent and reliable tests establishing this lack of deception; and a requirement that the supporting data be maintained for a period of two years. However, the Commission declined to modify Paragraph Four on the ground that petitioners had not demonstrated that the requested modification to remove the broadcast advertisement disclosure requirement regarding the incompatibility of some "Hot Wheels" toys with others is supported by a change in law, change in fact or the public interest.

ORDER REOPENING THE PROCEEDINGS AND MODIFYING CEASE AND DESIST ORDERS

On January 19, 1984, Mattel, Inc., and Ogilvy & Mather U.S., a Division of Ogilvy & Mather International Inc., (successor corporation to Carson Roberts, Inc.), respondents in the above captioned matter, filed a joint petition pursuant to Rule 2.51 of the Commission's Rules of Practice to reopen the proceedings and modify the consent orders entered therein. [79 F.T.C. 667, 674 (1971)] By letters dated June 7, 1984, June 21, 1984, July 19, 1984, and August 13, 1984, Petitioners modified their original joint proposal.

The Orders relate to alleged unfair and deceptive practices by Mattel and Carson-Roberts in connection with the advertising of toy racing sets and dancing or walking dolls. The first three paragraphs of the Orders against the two petitioners are substantively identical. These paragraphs: (1) prohibit the use of certain film or camera techniques in advertising addressed to children that misrepresent the product's performance, operation or use, (2) limit the circumstances under which endorsements may be used in advertising addressed to children, and, (3) require that, whenever two or more "Hot Wheels" products which are sold separately are advertised together, that separate status be disclosed. Paragraph Four of the Order against Ogilvy & Mather requires a disclosure in broadcast advertising regarding the incompatibility of some Hot Wheels products with other Hot Wheels products. Paragraph Four of the Order against Mattel requires this disclosure in print advertising and on packages as well as in broadcast advertising. The Order against Mattel also prohibits the misrepresentation of the velocity at which a toy car travels (Paragraph Five) and requires a disclosure regarding the ability of dancing or walking dolls to stand by themselves (Paragraph Six).

Petitioners seek modification only of Paragraphs One and Four of the Order—the paragraphs restricting the use of certain camera techniques[1] and requiring compatibility disclosures. Petitioners seek to add a proviso to Paragraph One of the Order. This proviso would state that respondents' use of the camera techniques restricted by Paragraph One would not constitute a violation of that Paragraph as long as they possessed and relied upon results of competent and reliable tests showing that such techniques, in the context of the advertisement as a whole, do not misrepresent the advertised product's performance to the age group of children to whom the advertisement is addressed. Petitioners also propose a provision which requires that proper records pertaining to these tests be maintained.[2]

Petitioners argue that the addition of this proviso to the Orders is in the public interest. They point out that the current Order does not flatly prohibit the use of the camera techniques described in Paragraph One. They are proscribed only if the result of their use "in the context of the advertisement as a whole is to misrepresent the product's performance, operation or use to the age groups of children to whom the advertisement is addressed, taking into consideration the level of knowledge, sophistication, maturity, and experience of such age group or age groups." Paragraph 1, Clauses (a)(b)(c) and (d). Petitioners claim that even though the Order is thus not designed to totally ban the use of these camera techniques, such is its practical effect. They argue that the order language fails to give them clear guidance by which they can tailor their actions for compliance, and that whether any given use of a particular camera technique in a particular advertisement "misrepresents" the product can only be decided in a post hoc Commission civil penalty action. Therefore, to avoid such an action, they must totally abstain from the use of such techniques.

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[1] These techniques are: (1) the use of "any visual perspective . . . which purports to be but is not one which a child can experience . . .;" (2) "[a]ny sequence of different visual perspectives which purports to depict perspectives which a child can experience but which changes faster than a child can change his visual perspective . . .;" (3) "[a]ny visual perspective which purports to depict the actual performance of a particular function of the product and which differs substantially from the length of time required to perform that function . . .;" and (4) "[c]amera over-cranking or under-cranking to depict a performance characteristic of such product which does not exist or cannot be perceived under ordinary conditions of the product's use. . . ." [79 F.T.C. 672, 679 (1971)]

[2] Ogilvy & Mather, successor to Carson-Roberts, Inc., also proposes that the name, Ogilvy & Mather U.S., a division of Ogilvy & Mather International, Inc., be substituted for the name Carson-Roberts, Inc., wherever the latter name appears in the Order in Docket C-2072.

Petitioners also propose that Paragraph Four of the original Orders be modified to remove the broadcast advertisement disclosures currently required. In place of these disclosures, Paragraph Four of the Mattel Order would be modified to require all package disclosures to appear on the front of the packages. Also, the clear and conspicuous standard would be applied to both the package and print advertising disclosure requirements. Finally, Paragraph Four of the Ogilvy & Mather Order would be modified to include the same package front and print advertising requirements as in Paragraph Four of the Mattel Order.

The Commission believes that the proposed proviso to Paragraph One is in the public interest. The theory behind the Orders clearly was not that the specified camera techniques are always deceptive. Had it been so, they would simply have been prohibited in all circumstances. The Orders do not proscribe those techniques, but only prohibit their use when the effect of such is to misrepresent the product's performance. The practical effect of the Orders, however, appears to be to raise substantial questions with regard to what constitutes proper compliance with Paragraph One. The proviso would allow the non-deceptive use of these camera techniques. Petitioners would have to possess and rely upon competent and reliable tests establishing this lack of deception. The requested modification would thus provide Petitioners with additional guidance as to the circumstances under which these camera techniques may be used while continuing to prevent that advertising from misrepresenting the performance of the advertised products.

However, the Commission has determined that Petitioners have not demonstrated that the requested modifications in Paragraph Four of the Orders are supported by a change in law, change in fact or the public interest. Petitioners argue that consumers are clearly aware that some Hot Wheels vehicles are not compatible with some Hot Wheels playsets, and can determine from pre-purchase visual inspection which vehicles are compatible with which sets. However, Petitioners present no evidence in support of this assertion. Furthermore, Commission staff attempted to test Petitioners' assertion by examining one Hot Wheels set and a variety of Hot Wheels vehicles. Staff was unable to reliably predict from visual inspection which vehicles would be compatible with the set. Petitioners also argue that the broadcast advertisement disclosures currently required by the Order provide no consumer benefit. They claim that an order which requires package-front disclosures, rather than broadcast disclosures and written disclosures which may be placed anywhere on the package, would provide better protection to consumers. However, Petitioners have presented no evidence to support this claim. The Commission concludes that Petitioners' arguments for the modification of Paragraph Four of the Orders do not meet the requirements of Section 2.51(b) of the Commission's Rules of Practice.

By letter of August 13, 1984, Petitioners requested that the Commission reopen the proceedings to modify both Paragraphs One and Four of the Orders, or, in the alternative, if the Commission should decide not to reopen the proceedings to modify both of those Order paragraphs, that the Commission reopen the proceedings to modify just Paragraph One as they have requested or reopen the proceedings to modify just Paragraph Four as they have requested. The Commission accepts only Petitioners' alternative request to reopen the proceedings solely to modify Paragraph One of the Orders. The Commission denies Petitioners' other requests to reopen the proceedings for the purpose of modifying both Paragraphs One and Four of the Orders and to reopen the proceedings for the purpose of modifying only Paragraph Four of the Orders.

The modified Orders will ensure that Petitioners' use of the camera techniques specified therein is not deceptive. At the same time, Petitioners' duties under the Orders have been clarified and their burdens of compliance lessened.

It is therefore ordered, That the proceeding in Docket Number C-2071 is hereby reopened and the Order issued November 1, 1971, is hereby modified as follows:

1. The following language shall be added to the end of Paragraph 1 of the Order.

Provided, however, That respondent shall not be in violation of the provisions of this paragraph if, at the time an advertisement incorporating any visual perspective or film or camera technique described in this paragraph is broadcast, respondent possesses and relies upon a test(s) which compares the impressions created by two advertisements which are identical except for the presence or absence of the visual perspective(s) or film or camera technique(s) being tested, and which is sufficiently sensitive to measure differences between the impressions conveyed by the advertisements with an accuracy of plus or minus less than five (5) percentage points, and which is otherwise competent and reliable, or any other competent and reliable test(s), which demonstrate(s) that such visual perspective(s) or film or camera technique(s), in the context of the advertisement as a whole, does not misrepresent the product's performance, operation, or use to the age group or age groups of children to whom the advertisement is addressed, taking into consideration the level of knowledge, sophistication, maturity, and experience of such age group or age groups. "Competent and reliable" shall mean for purposes of this Order a test conducted and evaluated in an objective manner by persons qualified to do so, using procedures generally accepted by others in that profession to yield accurate and reliable results.

2. The following paragraph shall be added following Paragraph 6.

It is further ordered, That respondent Mattel, Inc., shall maintain for at least two years from the date of the last dissemination of the representation, and upon request make available to the Federal Trade Commission for inspection and copying, all test results, data, and other documents or information relied upon for any representation containing any visual perspective(s) or film or camera technique(s) described in Paragraph 1 of this Order, and any information possessed or known of which contradicts, qualifies or calls into serious question that representation.

It is further ordered, That the proceeding in Docket Number C–2072 is hereby reopened and the Order issued November 1, 1971, is hereby modified as follows:

1. The corporate name, Ogilvy & Mather U.S., a division of Ogilvy & Mather International, Inc., shall be substituted for the corporate name Carson-Roberts, Inc., wherever the name Carson-Roberts, Inc., appears in this Order.

2. The following language shall be added to the end of Paragraph 1 of the Order.

Provided, however, That respondent shall not be in violation of the provisions of this paragraph if, at the time an advertisement incorporating any visual perspective or film or camera technique described in this paragraph is broadcast, respondent possesses and relies upon a test(s) which compares the impressions created by two advertisements which are identical except for the presence or absence of the visual perspective(s) or film or camera technique(s) being tested, and which is sufficiently sensitive to measure differences between the impressions conveyed by the advertisements with an accuracy of plus or minus less than five (5) percentage points, and which is otherwise competent and reliable, or any other competent and reliable test(s), which demonstrate(s) that such visual perspective(s) or film or camera technique(s), in the context of the advertisement as a whole, does not misrepresent the product's performance, operation, or use to the age group or age groups of children to whom the advertisement is addressed, taking into consideration the level of knowledge, sophistication, maturity, and experience of such age group or age groups. "Competent and reliable" shall mean for purposes of this Order a test conducted and evaluated in an objective manner by persons qualified to do so, using procedures generally accepted by others in that profession to yield accurate and reliable results.

3. The following paragraph shall be added following Paragraph 4.

It is further ordered, That respondent Ogilvy & Mather U.S., a division of Ogilvy & Mather International, Inc., shall maintain for at least two years from the date of the last dissemination of the representation, and upon request make available to the Federal Trade Commission for inspection and copying, all test results, data, and other documents or information relied upon for any representation containing any visual perspective(s) or film or camera technique(s) described in Paragraph 1 of this Order, and any information possessed or known of which contradicts, qualifies or calls into serious question that representation.

Commissioner Pertschuk dissented.

DISSENTING STATEMENT OF COMMISSIONER MICHAEL PERTSCHUK

The Commission today takes yet another giant step backward from protecting children against commercial exploitation. By agreeing to modify these 1971 orders, the Commission continues to ease the restraints against the sophisticated psychological manipulation of six, seven and eight year olds.

The 1971 orders against Mattel and its ad agency were entered to settle charges that ads for Mattel's "Hot Wheels" toys made the toys look bigger and move faster than they would appear to children. Although the orders did not ban Mattel's use of the questionable video techniques, for thirteen years Mattel apparently felt constrained from using a distorted sales pitch to sell its toys. But armed with the knowledge that the current Commission refuses to take a hard look at advertising directed to children,[1] last January Mattel pleaded hardship and asked the Commission to lift the burden of the orders.[2]

The solution agreed to by the Commission permits Mattel to use the techniques listed in the 1971 orders as long as Mattel's comparative testing of the camera techniques on two groups of children shows that the ads do not misrepresent the toys. But comparative testing of ads directed toward children is not adequate. I am skeptical that techniques for testing children's perceptions are sufficiently reliable to demonstrate that an ad is nondeceptive. As the FTC staff noted in its 1983 recommendation to close the Children's Advertising Rulemaking, "[Y]oung children do not possess the cognitive ability to evaluate adequately child-oriented television advertising." To the best of my knowledge, the Commission has previously respected this fact and has never before entered an order that incorporates a requirement for testing directed at children. Mattel has not presented any reason why the Commission should alter this long-standing policy and chance sanctioning deception.

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[1] For a more complete critique of the Commission's recent approach to children's advertising, *see* my Report to the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, "The Performance of the Federal Trade Commission, 1977-1984," at IV-61 - IV-70.

[2] In its petition, Mattel noted that the staff has recently closed investigations of two of its competitors for using video techniques similar to those prohibited by the 1971 orders. The fact that those cases were not pursued is indeed worthy of public attention—since they demonstrate the Commission's continuing abdication of its statutory role as the ad cop. But the closing of these cases should have no bearing on the Commission's decision about Mattel.

IN THE MATTER OF

THOMAS A. DARDAS

CONSENT ORDER, ETC. IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket C-3144. Complaint, Oct. 1, 1984—Decision, Oct. 1, 1984

This consent order requires Thomas A. Dardas, individually and as an officer of Acu-Form Weight Control Centers, Inc., to cease representing that any weight control or weight loss product or service can perform in any way or has any benefit, unless such representations are substantiated by reliable and competent evidence Mr. Dardas is also prohibited from misrepresenting the terms and conditions of guarantees offered in connection with any weight control or weight loss product or service; representing that any such product or service is guaranteed without prominently disclosing the identity of the guarantor and the conditions and limitations of the guarantee; and the manner in which the guarantor will perform guaranteed obligations. Additionally, Mr. Dardas is required, for a period of three years, to maintain records substantiating claims covered by this order; retain records detailing refund requests; and notify the Commission of any change in his employment.

Appearances

For the Commission: *Elaine Kolish.*

For the respondent: *Mark Miller, Gunn, Lee & Jackson,* San Antonio, Texas.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that Thomas A. Dardas, hereinafter referred to as respondent, individually and as an officer of Acu-Form Weight Control Centers, Inc., has violated the provisions of said Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

PARAGRAPH 1. Acu-Form Weight Control Centers, Inc., hereinafter referred to as the corporation, is a corporation organized, existing, and doing business under and by virtue of the laws of the State of Texas, with its principal office and place of business located at 4151 Southwest Freeway, Suite 410, Houston, Texas. The corporation filed a bankruptcy petition pursuant to Chapter 7 of Title 11 of the United States Code on August 2, 1983.

PAR. 2. Thomas A. Dardas is an individual and is an officer of the corporation. He formulates, directs, and controls the acts and practices of the corporation, including the acts and practices hereinafter set forth. His address is 11211 Valley Spring, Houston, Texas.

PAR. 3. Respondent, through the corporation, has engaged in the distribution, advertising, and sale of weight loss or weight control products and services sold under the name Acu-Form ear mold and has maintained a substantial course of trade in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act.

PAR. 4. Respondent, through the corporation, has disseminated and caused the dissemination of certain advertisements for the Acu-Form ear mold.

PAR. 5. Respondent, through the corporation and by means of the advertisements referred to in Paragraph Four, examples of which are attached hereto as Exhibits A-E, has made the following and other statements concerning the characteristics, performance and efficacy of ACU-FORM ear molds:

> a. Now, with the ACU-FORM ear mold, you can lose weight—quickly, safely, effortlessly! No drugs, needles or discomfort. No restrictions on your lifestyle. The Acu-Form ear mold simply suppresses your appetite. You eat less and lose weight.
>
> b. THE REDUCING AID YOU WEAR IN YOUR EAR (headline) The ACU-FORM ear mold is different from any other weight loss program. . . . The ACU-FORM ear mold actually decreases your appetite and lets you lose weight—quickly, safely and with no limits on your lifestyle!
>
> c. An ACU-FORM ear mold, custom fitted to your ear, puts you in control of your appetite and weight for life. . . .
>
> d. The ACU-FORM ear mold uses the body's own reflex mechanism to give you control of your appetite and weight. There are more than 200 clusters of invisible nerve endings in the shell of your ear which are specific acupuncture receptor points that can affect your habits. The specific points to modify your appetite and eating habits are stimulated by the ACU-FORM ear mold which remains in your ear and is virtually undetectable.
>
> e. BEFORE YOU READ THIS ADD PRESS LIGHTLY ON YOUR RIGHT EAR. (headline) Sound easy enough? That's all you do to help yourself lose weight—when you wear the unique Acu-Form ear unit.
>
> f. Granted U.S. Patent number 4,073,296, the clinically tested ACU-FORM ear mold is fast and effective.

PAR. 6. Through the advertisements referred to in Paragraph Four, including the statements set forth in Paragraph Five (a)-(e) and others, respondent, through the corporation, has represented, directly or by implication, that:

a. The Acu-Form ear mold is an effective means of weight loss.

b. The Acu-Form ear mold physiologically decreases or suppresses the wearer's appetite.

c. The Acu-Form ear mold gives the wearer permanent, life-time control over his or her weight.

PAR. 7. By the means of the advertisements referred to in Paragraph Four, respondent, through the corporation, has represented, directly or by implication, that at the time of making such representation, the corporation possessed and relied upon a reasonable basis for the representations set forth in Paragraph Six.

PAR. 8. In truth and in fact, the corporation did not possess and rely upon a reasonable basis for making such representations. Therefore, the representation set forth in Paragraph Seven was false and deceptive.

PAR. 9. By means of the statements set forth in Paragraph Five (f) and others, respondent, through the corporation, has represented that the Acu-Form ear mold's ability to suppress or decrease the wearer's appetite has been proven through clinical tests.

PAR. 10. In truth and in fact, the Acu-Form ear mold's ability to suppress or decrease the wearer's appetite has not been proven through clinical tests. Therefore, the representation set forth in Paragraph Nine was false and deceptive.

PAR. 11. Respondent through the corporation and by means of the advertisements referred to in Paragraph Four has made the following and other statements concerning a money-back guarantee for Acu-Form ear molds:

> a. If you want to lose weight, remember Acu-Form Weight Control Centers offer a 100% money back guarantee. You must lose weight or your money will be refunded in full.
>
> b. Money Back Guarantee.

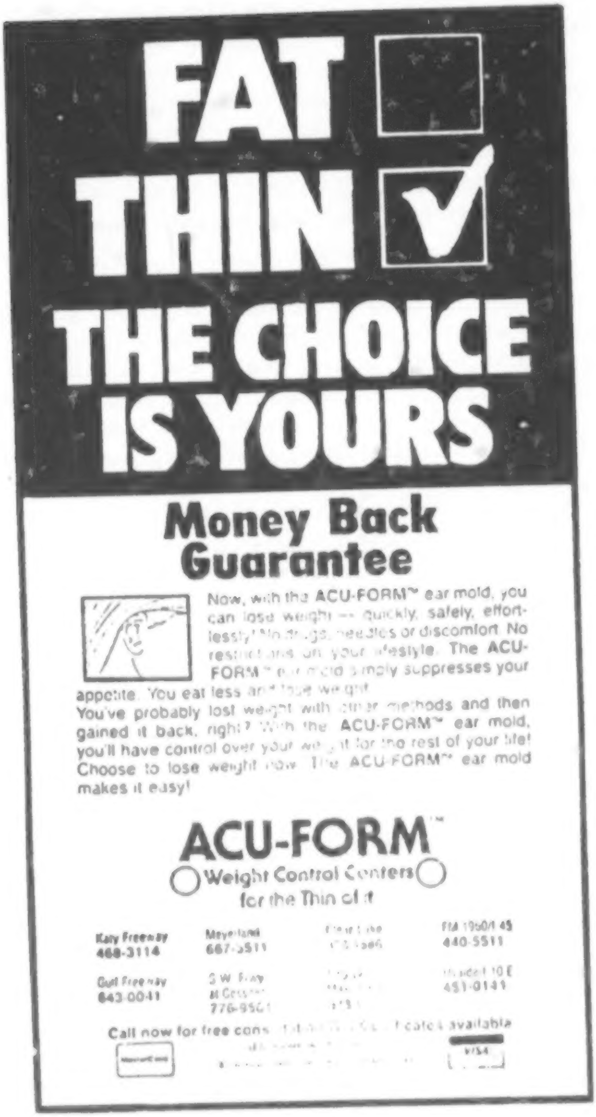
PAR. 12. Through the use of the statements set forth in Paragraph Eleven and others, respondent, through the corporation, has represented, directly or by implication, that the money-back guarantee was unconditional.

PAR. 13. In truth and in fact, there were significant conditions attached to the money-back guarantee, including, but not necessarily limited to the following, consumers must have (a) followed the Acu-Form Diet Handbook and (b) returned to the location of their purchase during its normal business hours to be weighed and counseled for six consecutive weeks following delivery of their device. Therefore, the representation set forth in Paragraph Twelve was false and deceptive.

PAR. 14. Respondent's use of the aforesaid unfair and deceptive acts and practices has had the capacity and tendency to mislead consumers and to induce consumers to purchase Acu-Form ear molds.

Par. 15. The acts and practices of respondent, as herein alleged, were and are all to the prejudice and injury of the public and constitute unfair and deceptive acts or practices in or affecting commerce, in violation of Section 5 of the Federal Trade Commission Act.

EXHIBIT A



FAT ☐

THIN ☑

THE CHOICE IS YOURS

Money Back Guarantee

Now, with the ACU-FORM™ ear mold, you can lose weight — quickly, safely, effortlessly! No drugs, needles or discomfort. No restrictions on your lifestyle. The ACU-FORM™ ear mold simply suppresses your appetite. You eat less and lose weight.

You've probably lost weight with other methods and then gained it back, right? With the ACU-FORM™ ear mold, you'll have control over your weight for the rest of your life! Choose to lose weight now. The ACU-FORM™ ear mold makes it easy!

ACU-FORM™

Weight Control Centers

for the Thin of it

Katy Freeway
468-3114

Meyerland
667-5511

Clear Lake
[illegible]

FM 1960/I-45
440-5511

Gulf Freeway
643-0041

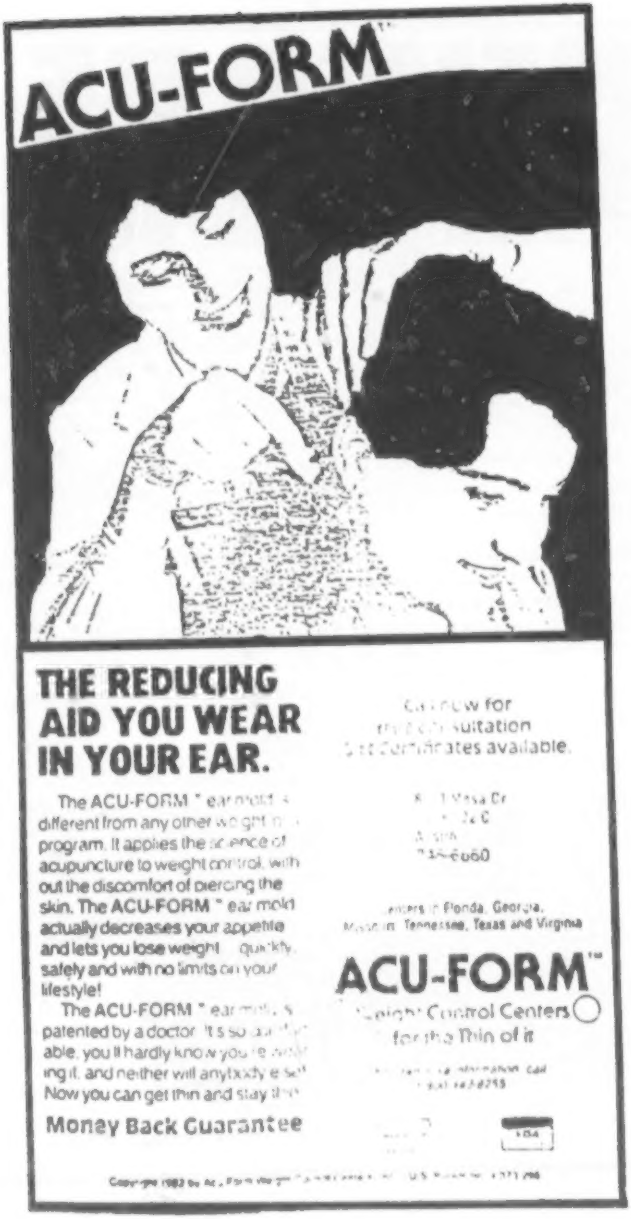
S.W. Fwy
at Gessner
776-9561

[illegible]

[illegible] 10 E
451-0141

Call now for free cons[illegible] [illegible]ficates available

EXHIBIT B



THE REDUCING AID YOU WEAR IN YOUR EAR.

The ACU-FORM™ ear mold is different from any other weight [illegible] program. It applies the science of acupuncture to weight control, without the discomfort of piercing the skin. The ACU-FORM™ ear mold actually decreases your appetite and lets you lose weight quickly, safely and with no limits on your lifestyle!

The ACU-FORM™ ear mold is patented by a doctor. It's so comfortable, you'll hardly know you're wearing it, and neither will anybody else! Now you can get thin and stay thin.

Money Back Guarantee

Call now for free consultation. Gift Certificates available.

[illegible] Mesa Dr
[illegible] C
Austin
[illegible]-6060

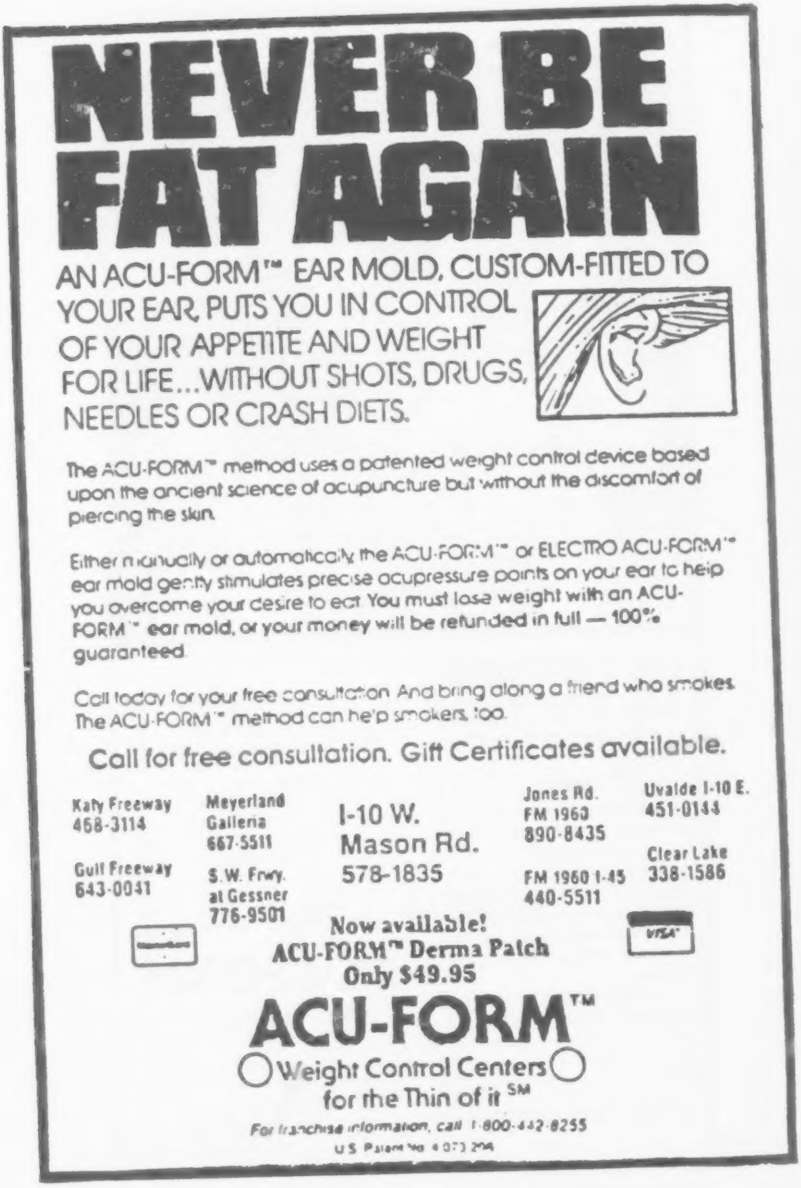
Centers in Florida, Georgia, Missouri, Tennessee, Texas and Virginia

ACU-FORM™
Weight Control Centers
for the Thin of it

For franchise information call [illegible]

Copyright 1982 by Acu-Form Weight Control Centers Inc. U.S. Patent No. [illegible]

EXHIBIT C



NEVER BE FAT AGAIN

AN ACU-FORM™ EAR MOLD, CUSTOM-FITTED TO YOUR EAR, PUTS YOU IN CONTROL OF YOUR APPETITE AND WEIGHT FOR LIFE...WITHOUT SHOTS, DRUGS, NEEDLES OR CRASH DIETS.

The ACU-FORM™ method uses a patented weight control device based upon the ancient science of acupuncture but without the discomfort of piercing the skin.

Either manually or automatically the ACU-FORM™ or ELECTRO ACU-FORM™ ear mold gently stimulates precise acupressure points on your ear to help you overcome your desire to eat. You must lose weight with an ACU-FORM™ ear mold, or your money will be refunded in full — 100% guaranteed.

Call today for your free consultation. And bring along a friend who smokes. The ACU-FORM™ method can help smokers, too.

Call for free consultation. Gift Certificates available.

Katy Freeway
468-3114

Gulf Freeway
643-0041

Meyerland
Galleria
667-5511

S.W. Frwy.
at Gessner
776-9501

I-10 W.
Mason Rd.
578-1835

Jones Rd.
FM 1960
890-8435

FM 1960 I-45
440-5511

Uvalde I-10 E.
451-0144

Clear Lake
338-1586

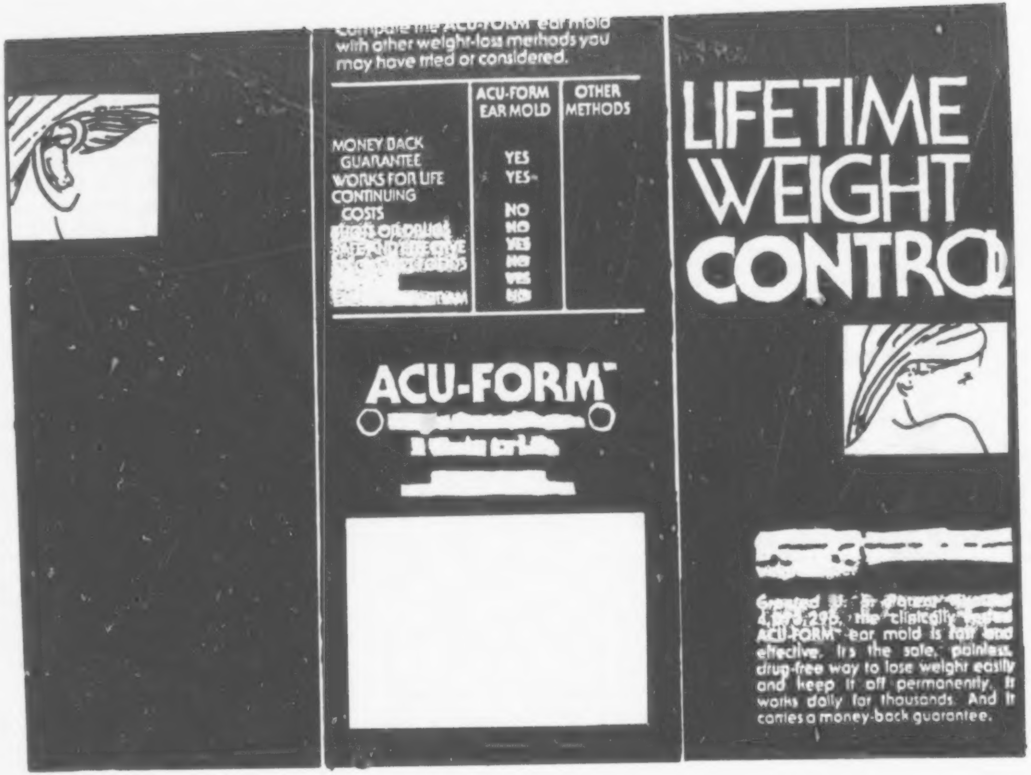
Now available!
ACU-FORM™ Derma Patch
Only $49.95

ACU-FORM™
Weight Control Centers
for the Thin of it℠

For franchise information, call 1-800-442-8255

U.S. Patent No. 4 073 296

EXHIBIT D



Compare the ACU-FORM ear mold with other weight-loss methods you may have tried or considered.

	ACU-FORM EAR MOLD	OTHER METHODS
MONEY BACK GUARANTEE	YES	
WORKS FOR LIFE	YES	
CONTINUING COSTS	NO	
[illegible]	NO	
SAFE AND EFFECTIVE	YES	
[illegible]	NO	
[illegible]	YES	
[illegible]	NO	

ACU-FORM™
[illegible]
It Works for Life.
LIFETIME WEIGHT CONTROL

[illegible]

Granted [illegible] 4,[illegible],296, the clinically [illegible] ACU-FORM™ ear mold is [illegible] and effective. It's the safe, painless, drug-free way to lose weight easily and keep it off permanently. It works daily for thousands. And it carries a money-back guarantee.

SAY "GOODBYE" TO FAT FOR LIFE

The **ACU-FORM**™ ear mold was invented and patented by Dr. F. J. McCall. It applies the centuries-old science of acupuncture to weight control, but without the discomfort of piercing the skin.

The **ACU-FORM**™ ear mold uses the body's own reflex mechanism to give you control of your appetite and weight. There are more than 200 clusters of invisible nerve endings in the shell of your ear which are specific acupuncture receptor points that can affect your habits. The specific points to modify your appetite and eating habits are stimulated by the **ACU-FORM**™ ear mold which remains in your ear and is virtually undetectable.

After an extensive training program, our technicians are certified to make the impression required to produce the **ACU-FORM**™ ear mold that fits your ear precisely. A unique plastic material is used to make an impression of your outer ear. This safe, painless process takes just 10 minutes.

The technician will examine the impression to be certain that it conforms to your ear. It will then be sent to the laboratory where a translucent ACUFORM™ ear mold is made. Surgical grade stainless steel stimulators are imbedded in the mold at the precise acupuncture points for your ear.

When the completed mold is returned from the laboratory, the technician will check it for fit and comfort and enroll you in our Weight Control Program.

That's all there is to it. But it means you are on your way to a more fulfilling life with control of your appetite and weight.

As you begin to reduce to your most desirable weight, you will feel an increased sense of physical well-being with improved self-assurance and the happiness that goes with them.

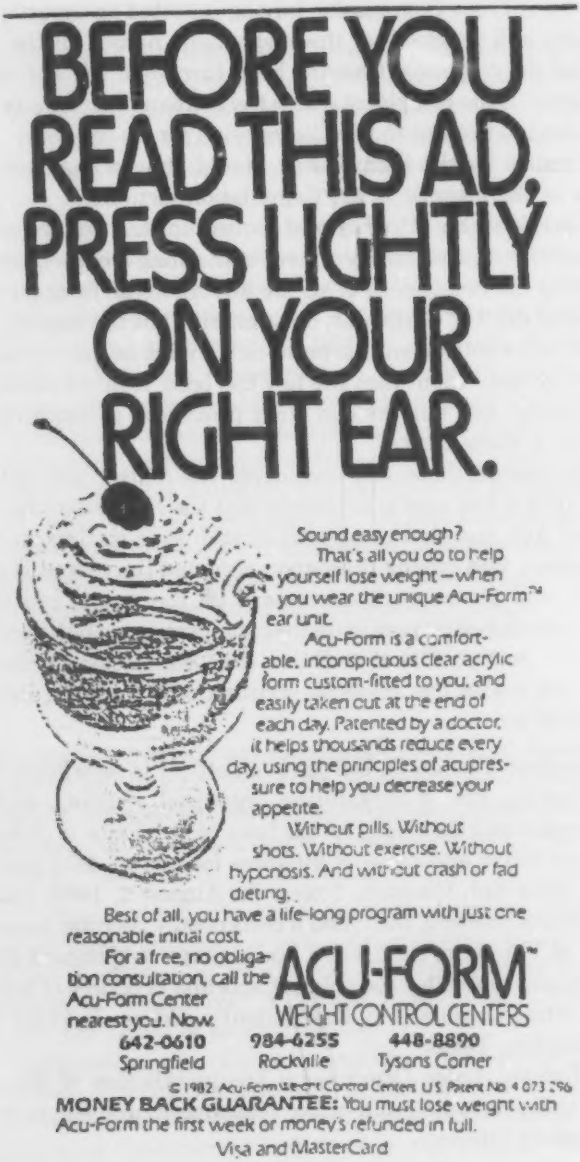
We hope that you will share your knowledge of the **ACU-FORM**™ ear mold with your friends and relatives who may need help in controlling their weight.

Dr. McCall is President of McCall Research Develop
Laboratories, Ltd. and an author and lecturer who h
many patents on prosthetics. He has a Ph.D. in Diet
and Nutritional Physiology, as well as Naturopathy.
holds a degree of Doctor of Medicine and is a Staff M
ber and Instructor at The Chinese Acupuncture Hosp
Taiwan, President of the American Chapter of the Chi
Acupuncture Society, holder of the Certificate of Merit
medal First Class Acupuncture, conferred Taipei City
Taiwan, 1973

"ACU-FORM" and ACU-MOLD" are registered trademarks of ACU-FORM" Weight Control Centers, Inc."

Copyright [illegible] by Acu-Form Weight Control Centers, Inc

EXHIBIT E



BEFORE YOU READ THIS AD, PRESS LIGHTLY ON YOUR RIGHT EAR.

Sound easy enough?

That's all you do to help yourself lose weight—when you wear the unique Acu-Form™ ear unit.

Acu-Form is a comfortable, inconspicuous clear acrylic form custom-fitted to you, and easily taken out at the end of each day. Patented by a doctor, it helps thousands reduce every day, using the principles of acupressure to help you decrease your appetite.

Without pills. Without shots. Without exercise. Without hypnosis. And without crash or fad dieting.

Best of all, you have a life-long program with just one reasonable initial cost.

For a free, no obligation consultation, call the Acu-Form Center nearest you. Now.

ACU-FORM™
WEIGHT CONTROL CENTERS

642-0610	984-6255	448-8890
Springfield	Rockville	Tysons Corner

© 1982 Acu-Form Weight Control Centers U.S. Patent No. 4 073 296

MONEY BACK GUARANTEE: You must lose weight with Acu-Form the first week or money's refunded in full.

Visa and MasterCard

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of the complaint which the Bureau of Consumer Protection proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violations of the Federal Trade Commission Act; and

The respondent, his attorney and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of such agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission thereafter considered the matter and having determined that it had reason to believe that the respondent has violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings, and enters the following order:

1. Respondent Thomas A. Dardas is an officer of Acu-Form Weight Control Centers, Inc., a corporation organized, existing, and doing business under and by virtue of the laws of the State of Texas with its principal office and place of business located at 4151 Southwest Freeway, Suite 410, Houston, Texas. On August 2, 1983, Acu-Form Weight Control Centers, Inc., filed a bankruptcy petition pursuant to Chapter 7 of Title 11 of the United States Code. Respondent directed, formulated and controlled the policies, acts and practices of Acu-Form Weight Control Centers, Inc. Respondent's address is 11211 Valley Spring, Houston, Texas.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

I.

It is ordered, That respondent Thomas A. Dardas, individually and as an officer of Acu-Form Weight Control Centers, Inc., and his agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, offering for sale, sale or distribution of any product or service marketed for weight loss or weight control in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from representing in any manner, directly or by implication, that any weight loss or weight control product or service is effective, is able to perform in any respect, or has any characteristic, feature, attribute, or benefit unless at the time that such representation is made respondent possesses and relies upon reliable and competent evidence that substantiates the representation; *provided, however,* that to the extent the evidence of a reasonable basis consists of tests, analyses, research, studies or any other materials based on the expertise of professionals in the relevant area, such evidence shall be "reliable and competent" for the purposes of this order only if those tests, analyses, research, studies, or other materials are conducted and evaluated in an objective manner by persons qualified to do so, using procedures generally accepted in the profession to yield accurate and reliable results.

II.

It is further ordered, That respondent Thomas A. Dardas, individually and as an officer of Acu-Form Weight Control Centers, Inc., and his agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, do forthwith cease and desist from:

a. misrepresenting, directly or by implication, in connection with the advertising, offering for sale, sale or distribution of any product or service marketed for weight loss or weight control in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, the terms of any guarantee;

b. representing, directly or by implication, in connection with the advertising, offering for sale, sale or distribution of any product or service marketed for weight loss or weight control in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, that any such product or service is guaranteed unless:

(1) the identity of the guarantor, the nature, extent, and material conditions of the guarantee, and the manner in which the guarantor will perform thereunder are clearly and prominently disclosed; and

(2) the guarantor does in fact perform all of the obligations under the terms of the guarantee as represented.

III.

It is further ordered, That respondent shall promptly notify the Commission of the discontinuance of his present business or employment and of his affiliation with a new business or employment and that for a period of three (3) years from the date of service of this order respondent shall promptly notify the Commission of each affiliation with a new business or employment. Each such notice shall include respondent's new business address and a statement of the nature of the business or employment in which respondent is newly engaged as well as a description of respondent's duties and responsibilities in connection with each new business or employment.

IV.

It is further ordered, That for three (3) years after receiving any request for a refund in connection with the sale of any weight control or weight loss product or service, respondent shall maintain and upon request make available to the Federal Trade Commission for inspection and copying the following records:

a. the name and address of each customer requesting the refund;

b. the date that respondent received the request for the refund;

c. if a refund was granted, a copy of the request (if written), the amount of the refund and date that it was sent to the customer;

d. if a refund was denied, a copy of the request (if written) and a copy of the written explanation of the denial sent to the customer.

V.

It is further ordered, That respondent shall maintain for three (3) years after the date of the last dissemination and upon request make available to the Federal Trade Commission for inspection and copying all materials relied upon in disseminating any representation covered by this order.

VI.

It is further ordered, That respondent shall, within sixty (60) days after service upon him of this order, file with the Commission a report, in writing, setting forth in detail the manner and form in which he has complied with this order.

IN THE MATTER OF

THE SPERRY & HUTCHINSON COMPANY

MODIFYING ORDER IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT

Docket 8671. Final Order, Sept. 18, 1973—Modifying Order, Oct. 3, 1984

After reviewing the "Request To Reopen And Modify Order" filed by The Sperry & Hutchinson Company ("S&H"), the Commission concluded that it was in the public interest to set aside Section I of a Consent Order issued on September 18, 1973, 83 F.T.C. 478, which required the company to redeem its trading stamps for cash as well as merchandise. The company demonstrated that due to changed conditions, consumers can now readily avoid both S&H stamps and trading stamps in general in virtually all markets, and thus avoid any injury that might result from a merchandise-only redemption policy. S&H further demonstrated that the cash redemption requirement is also injuring its ability to compete against other suppliers of promotional services that are not subject to comparable restraints. Finding that the cash redemption provision no longer served any legitimate remedial purpose, the Commission reopened the matter and set aside Section I of the 1973 Consent Order.

ORDER MODIFYING DECISION AND ORDER ISSUED SEPTEMBER 18, 1973

On July 6, 1984, respondent The Sperry & Hutchinson Company ("S&H") filed a "Request To Reopen And Modify Order" ("Request"), pursuant to Section 5(b) of the Federal Trade Commission Act, 15 U.S.C. 45(b) and Section 2.51 of the Commission's Rules of Practice. The Request asked the Commission to reopen and modify the consent order issued on September 18, 1973 ("the order") by setting aside Section I. Section I of the order requires S&H to redeem its trading stamps for cash at the option of the stamp saver, at a fixed cash redemption value, if the stamps are presented in minimum quantities of 300.

After reviewing respondent's Request, the Commission has concluded that the public interest warrants reopening and modification of the order by setting aside Section I.

At the time of the original proceeding in this matter trading stamps were so pervasive in the marketplace that many consumers found them difficult if not impossible to avoid. In such a context, the cash redemption requirement of the order afforded stamp-savers an alternative to respondent's traditional policy of redeeming its stamps only for merchandise. S&H has demonstrated that conditions have now changed to the extent that consumers can readily avoid both S&H stamps and trading stamps in general in virtually all markets and, as a consequence, can avoid any injury that might otherwise arguably result from a merchandise-only redemption policy. S&H has also shown that the continued existence of the cash redemption requirement is injuring its ability to compete against other suppliers of promotional services both inside and outside the trading stamp industry, which are not subject to comparable restraints. In view of these circumstances the cash redemption provision no longer serves any legitimate remedial purpose.

Accordingly, *it is ordered* that this matter be, and it hereby is, reopened, and that Section I of the Commission's order issued on September 18, 1973, shall be of no further force and effect as of the effective date of this order.

IN THE MATTER OF

SUN REFINING AND MARKETING COMPANY

CONSENT ORDER, ETC. IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket C-3145. Complaint, Oct. 11, 1984—Decision, Oct. 11, 1984

This consent order requires a Philadelphia, Pa. corporation, among other things, to honor the lifetime warranty on its "True Blue Lifetime Battery" ("TBLT"). The company is required to notify consumers who received a replacement battery without a lifetime warranty, that their original lifetime warranty rights would be reinstated. Further, when fulfilling warranty obligations, the company is required to provide replacement batteries that have the same technical and performance characteristics as the TBLT battery. The order also requires the firm to notify its dealers and distributors that it is reinstating the TBLT lifetime warranty and provide them with instructions for honoring the warranty.

Appearance

For the Commission: *Lemuel W. Dowdy* and *Rosemary Rosso.*

For the respondent: *E. Henneberry, Howrey & Simon,* Washington, D.C.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, as amended, and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that Sun Refining and Marketing Company, a corporation, hereinafter sometimes referred to as respondent, has violated the provisions of said Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

PARAGRAPH 1. Respondent Sun Refining and Marketing Company is a corporation organized, existing and doing business under and by virtue of the laws of the Commonwealth of Pennsylvania with its office and principal place of business located at 1801 Market Street, Philadelphia, Pennsylvania

PAR. 2. Respondent is and has been engaged in the advertising, offering for sale, sale and distribution of automotive batteries as well as other consumer products.

PAR. 3. In the course and conduct of its business, respondent causes and has caused its automotive batteries and other consumer products to be shipped to various states for sale to the public. For the purpose of inducing the purchase of its automotive batteries by the consuming public, and in a manner likely to induce the purchase of said products in commerce, respondent has disseminated and has caused the dissemination of certain advertisements and promotional materials through various means, including magazines and newspapers of national circulation, television broadcasts transmitted by television stations located in various states and having sufficient power to carry such broadcasts across state lines, and has distributed promotional materials through the use of the U.S. mail. Respondent, at all times mentioned herein, has maintained a substantial course of business, including the acts and practices hereinafter set forth which are in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act.

PAR. 4. Respondent sold or distributed approximately 281,000 automotive batteries with the brand name True Blue Lifetime Battery during the years 1975 through 1979. Each True Blue Lifetime Battery which respondent sold or distributed was accompanied by a written warranty.

PAR. 5. The warranties granted and disseminated to purchasers of respondent's True Blue Lifetime Battery were designated as a "Full Lifetime Warranty" or a "Lifetime Battery Warranty." Typical and illustrative of said warranties is Exhibit A attached hereto.

PAR. 6. In the further course and conduct of its aforesaid business and for the purpose of inducing the public to purchase respondent's True Blue Lifetime Battery, respondent has distributed advertising brochures and aired television advertisements which describe the True Blue Lifetime Battery as a battery that is sold with a full lifetime warranty. Typical and illustrative of said advertisements is Exhibit B attached hereto.

PAR. 7. By and through the acts, practices, statements and representations alleged in Paragraphs Two through Six above, respondent has represented, expressly or by implication, that the "Full Lifetime Warranty" and the "Lifetime Battery Warranty" obligate respondent to provide continuous free replacements for any battery that fails to accept and hold a charge as long as the purchaser owns the automobile in which the original True Blue Lifetime Battery was installed.

PAR. 8. In truth and in fact, respondent has not fully performed its obligations under the "Full Lifetime Warranty" and the "Lifetime Battery Warranty" as described in Paragraph Seven above. Beginning no later than July 15, 1980 respondent has implemented and is implementing a policy of refusing to provide continuous free replacements for any battery that fails to accept and hold a charge as long as the purchaser owns the automobile in which the original True Blue

Lifetime Battery was installed. Pursuant to this policy, respondent has offered and is offering the following options to purchasers of True Blue Lifetime Batteries when they seek warranty service:

1. Replacement with a battery of like grade and size but with warranty coverage limited to approximately fifty (50) months from the time of replacement; or

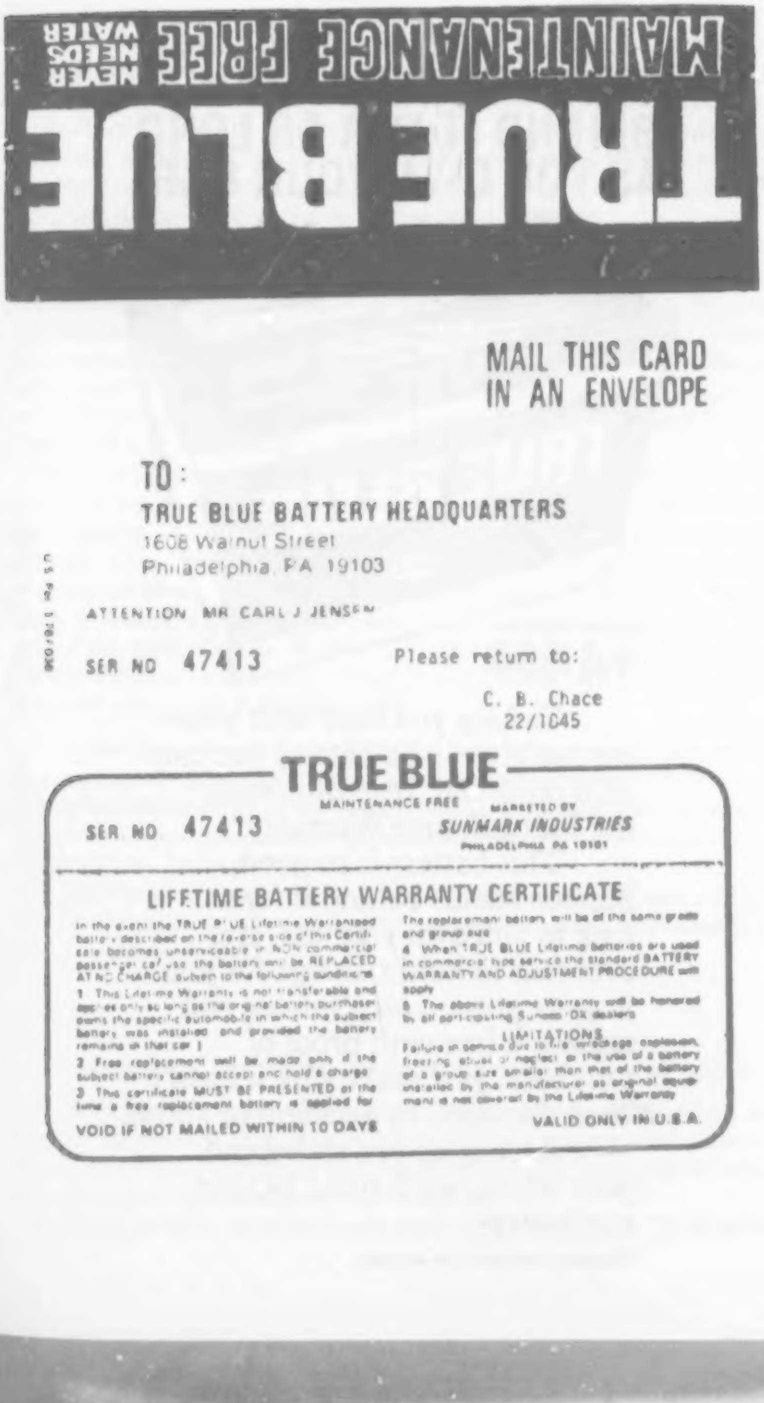
2. Refund of the original purchase price of the True Blue Lifetime Battery as indicated on the proof of purchase.

If these two options were or are unacceptable, purchasers are told to contact the Manager of Customer Relations for respondent. Pursuant to this policy, consumers were not and are not given the option of retaining the warranty rights described in Paragraph Seven above. Thus, a substantial number of purchasers of the True Blue Lifetime Battery have received or are receiving less warranty coverage than that which respondent was obligated to provide under the terms of the written warranty which was provided to purchasers at the time of purchase.

PAR. 9. Respondent's actions described above have thus caused substantial and ongoing injury to respondent's customers that is not outweighed by countervailing benefits to consumers or competition and is not reasonably avoidable by consumers.

PAR. 10. The acts and practices of respondent as alleged herein were and are all to the prejudice and injury of the public and constitute unfair acts or practices in or affecting commerce, in violation of Section 5(a) of the Federal Trade Commission Act.

EXHIBIT A



TRUE BLUE

MAINTENANCE FREE

NEVER NEEDS WATER

MAIL THIS CARD
IN AN ENVELOPE

TO:
TRUE BLUE BATTERY HEADQUARTERS
1608 Walnut Street
Philadelphia, PA 19103

U.S. Pat. [illegible]

ATTENTION MR CARL J JENSEN

SER NO 47413

Please return to:

C. B. Chace
22/1045

TRUE BLUE
MAINTENANCE FREE

SER NO 47413

MARKETED BY
SUNMARK INDUSTRIES
PHILADELPHIA PA 19101

LIFETIME BATTERY WARRANTY CERTIFICATE

In the event the TRUE BLUE Lifetime Warranteed battery described on the reverse side of this Certificate becomes unserviceable in NON commercial passenger car use, the battery will be REPLACED AT NO CHARGE subject to the following conditions:

1 This Lifetime Warranty is not transferable and applies only so long as the original battery purchaser owns the specific automobile in which the subject battery was installed and provided the battery remains in that car.

2 Free replacement will be made only if the subject battery cannot accept and hold a charge.

3 This certificate MUST BE PRESENTED at the time a free replacement battery is applied for. The replacement battery will be of the same grade and group size.

4 When TRUE BLUE Lifetime batteries are used in commercial type service the standard BATTERY WARRANTY AND ADJUSTMENT PROCEDURE will apply.

5 The above Lifetime Warranty will be honored by all participating Sunoco/DX dealers.

LIMITATIONS

Failure in service due to fire, wreckage, explosion, freezing, abuse or neglect, or the use of a battery of a group size smaller than that of the battery installed by the manufacturer as original equipment is not covered by the Lifetime Warranty.

VOID IF NOT MAILED WITHIN 10 DAYS

VALID ONLY IN U.S.A.

EXHIBIT B

OUR NEW TRUE BLUE. SUNOCO WILL STAND BEHIND IT FOR AS LONG AS YOU OWN YOUR CAR.

TRUE BLUE
TRUE BLUE
SUNOCO
DX

Suggested retail price
$\$44^{95}$

To help you hold onto your car, we give you a battery you can hold onto: our True Blue with the Full Lifetime Warranty.*

This battery is so good, Sunoco stands behind it for as long as you own your car. If it ever fails to hold a charge for you in your present car, Sunoco will replace it free with proof of purchase. Just make sure it hasn't been damaged by accident or abuse.

As long as you sit behind your wheel, we'll stand behind our battery.

*Commercial and marine use excluded.

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of Sun Refining and Marketing Company and the respondent having been furnished thereafter with a copy of a draft of complaint which the Bureau of Consumer Protection proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Federal Trade Commission Act; and

The respondent, its attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondents that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondents have violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent Sun Refining and Marketing Company is a corporation organized, existing and doing business under and by virtue of the laws of the Commonwealth of Pennsylvania, with its office and principal place of business located at 1801 Market Street, in the City of Philadelphia, State of Pennsylvania.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

For purposes of this order, the following definitions shall apply:

A. *Lifetime Warranty*—A warranty which obligates respondent to provide continuous free replacements for any battery that fails to accept and hold a charge as long as the purchaser owns the vehicle in which the original battery was installed.

B. *TBLT battery*—A battery sold under the brand name "True Blue

Lifetime Battery" and which carried a warranty entitled "Lifetime Battery Warranty" or "Full Lifetime Warranty."

I

It is ordered, That respondent Sun Refining and Marketing Company, a corporation, its successors and assigns, and its officers, representatives, agents and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, offering for sale, sale or distribution of any automotive battery in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

A. Failing to perform any written warranty obligation under the "Lifetime Battery Warranty" or the "Full Lifetime Warranty" or any other warranty offering continuous replacements for a failed battery and from failing to replace any such battery under any such warranty if it has failed while the purchaser owns the car in which the original battery was installed;

Provided, that nothing in this order, including Part II shall prevent respondent from requesting purchasers of batteries carrying a "Lifetime Battery Warranty" or a "Full Lifetime Warranty" or any other warranty offering continuous replacements for failed batteries to agree to a modification of the warranty so long as: (1) the purchasers are notified in writing that a modification of the written warranty terms is being sought; (2) the purchasers are notified that they have the option of not agreeing to the modification and may continue with existing warranty coverage if they desire (such option shall be stated clearly and conspicuously in the same notification that informs the purchasers that a modification is being sought); (3) the purchasers are notified of all changes in warranty coverage that would occur should the modification be accepted, including, but not limited to, changes in warranty duration, changes in what respondent as warrantor will do in the event of a defect in or failure of the warranted product, and changes in what items or services the purchasers must pay for or provide or which the warrantor will not pay for or provide. No modification of the terms of any such warranty shall take effect unless and until the purchaser agrees in writing to such modification.

II

It is further ordered, That:

A. Respondent, its successors and assigns, shall ascertain the name and address of each consumer who, according to the company's warranty files:

1. purchased a TBLT battery; and

2. replaced said battery (when the battery failed to accept and hold charges) with a battery of respondent that did not carry a lifetime warranty.

B. Within thirty (30) days after the date of service of this order, respondent, its successors and assigns, shall mail, by first class mail, address correction requested, to each consumer identified in Part II. A. of this order:

1. a notice (Attachment A of this order) that respondent, its successors and assigns, is reinstating the original lifetime warranty for consumers who still own the vehicle in which the original TBLT battery was installed; and

2. a self-addressed stamped post card (Attachment B of this order) which requests that the consumer provide information which will be used to determine whether he or she still owns the vehicle in which the original TBLT battery was installed.

The front of the envelope used for each such mailing shall clearly and conspicuously state: "IMPORTANT WARRANTY INFORMATION ENCLOSED."

C. Within thirty (30) days after receiving each such post card as described in Part II. B. 2 of this order indicating that the consumer still owns the vehicle in which the original TBLT battery was installed and that the model year of the vehicle is 1980 or earlier, respondent, its successors and assigns, shall mail, by first class mail, with a cover letter (Attachment C of this order), a lifetime warranty certificate that, as long as the consumer owns the vehicle in which the original battery was installed, may be used to obtain a free battery to replace any battery that fails to accept and hold a charge. The front of the envelope used for each such mailing shall clearly and conspicuously state: "IMPORTANT WARRANTY INFORMATION ENCLOSED."

D. For each consumer who was sent a notice and a post card pursuant to Part II. B. above, but whose notice was returned by the U.S. Postal Service for any reason, respondent, its successors and assigns, shall within sixty (60) days after the mailing pursuant to Part II. B:

1. search its credit card files and other records to obtain a current address for such consumer; and

2. re-mail to such current address, by first class mail, that notice and post card.

The front of the envelope used for each such mailing shall clearly and conspicuously state: "IMPORTANT WARRANTY INFORMATION ENCLOSED."

E. Within thirty (30) days after receiving any post card mailed pursuant to Part II. D. 2 indicating that the consumer still owns the vehicle in which the original TBLT battery was installed and that the model year of the vehicle is 1980 or earlier, respondent, its successors and assigns, shall mail, by first class mail, with a cover letter (Attachment C of this order), a lifetime warranty certificate that, as long as the consumer owns the vehicle in which the original battery was installed, may be used to obtain a free battery to replace any battery that fails to accept and hold a charge. The front of the envelope used for each such mailing shall clearly and conspicuously state: "IMPORTANT WARRANTY INFORMATION ENCLOSED."

F. For each consumer who presents evidence that:

1. he or she purchased a TBLT battery;

2. when that TBLT battery failed, it was replaced with one of respondent's batteries that did not carry a lifetime warranty; and

3. he or she still owns the vehicle in which the original TBLT battery was installed,

respondent, its successors and assigns, within thirty (30) days after receiving such evidence, shall mail by first class mail to that consumer:

1. a notice that respondent (or its successors and assigns) is reinstating the original lifetime warranty (such notification shall be stated in clear and conspicuous language); and

2. a lifetime warranty certificate that as long as the consumer owns the vehicle in which the original battery was installed may be used to obtain a free battery to replace any battery that fails to accept and hold a charge.

The front of the envelope used for such mailing shall clearly and conspicuously state: "IMPORTANT WARRANTY INFORMATION ENCLOSED."

III

It is further ordered, That:

A. If respondent, its successors and assigns replaces any failed battery as required by Parts I and II of this order, the replacement battery shall be at least of the same grade and group size as the original battery, meaning a battery having at least the same technical and performance characteristics as the original battery.

B. Within thirty (30) days after the date of service of this order, respondent shall provide written notice to every dealer and distributor who sells respondent's automotive batteries, stating that the lifetime warranty has been reinstated for purchasers of TBLT batteries and shall apply to replacement batteries installed after date of service of this order and giving a copy of the notices sent to consumers pursuant to Part II of this order and a set of instructions and procedures to be observed by respondent's dealers and distributors who are called upon to replace batteries having a lifetime warranty.

IV

It is further ordered, That:

A. Respondent shall notify the Commission at least thirty (30) days prior to any proposed change such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries, the dissolution of Sunmark Industries, or any change in the corporation which may affect compliance obligations arising out of the order.

B. Respondent, for a period of three (3) years from the date of service of this order, shall maintain and upon request make available to the Federal Trade Commission for inspection and copying all records reflecting respondent's compliance with this order, including the following:

1. copies of the notices required by Paragraphs B, C and D of Part II of this order, and all responses to such notices; and
2. copies of the notices required by Paragraph B of Part III of this order; and
3. records concerning the disposition of request from consumers for service, repair or money adjustments covered by this order pursuant to any lifetime warranty.

C. Within one-hundred and twenty (120) days after the date of service of this order, respondent shall file with the Commission a report in writing, setting forth in detail the manner and form in which it has complied with this order.

ATTACHMENT A

NOTICE TO FORMER TRUE BLUE LIFETIME BATTERY OWNERS

As part of an agreement with the Federal Trade Commission, Sun Refining and

Marketing Company (Sunoco) is offering lifetime warranty certificates to eligible purchasers of True Blue Lifetime (TBLT) batteries. If you qualify for a certificate, you will be able to get continuous free replacements for your battery whenever it fails to accept and hold a charge. You will be able to get free replacement batteries as long as you own the car in which the TBLT battery was first installed.

To qualify for the lifetime warranty certificate, you must have purchased a TBLT battery that failed and was replaced by a Sunoco battery that did not have a lifetime warranty. Our records indicate that this happened to you. In addition, you must still own the car in which the TBLT battery was first installed.

If you meet these qualifications, please complete the attached postage-paid card and return it. Please allow 45 days for delivery of your certificate. Remember, *the only way* to receive a certificate is to complete and return the attached card.

If you have any questions, please contact ____________________.

ATTACHMENT B

APPLICATION FOR LIFETIME WARRANTY CERTIFICATE

Name ____________________
Street Address ____________________
City __________ State __________ Zip __________
Date of original TBLT purchase* ____________________
Date battery was replaced* ____________________
Make, model, year, and license plate number of car in which TBLT was installed:
____
Signature ____________________

---

* If you do not know the exact date, an approximate date is acceptable.

(Allow approximately 45 days for delivery.)

ATTACHMENT C

Dear ____________________:

Here is your lifetime warranty certificate. This certificate is good only for the car in which the original TBLT battery was installed. If, at any time in the future, your battery fails to accept and hold a charge, you can use this certificate to get a new battery, free, from participating Sunoco/DX dealers or distributors. All you have to do is give the Sunoco/DX dealer or distributor the lifetime warranty certificate. Sunoco then will send you a new warranty certificate which you can use to obtain additional free replacement batteries for the car in which the original TBLT battery was installed.

If you have any questions, please contact ____________________.

IN THE MATTER OF

HOSPITAL AND HEALTH SERVICES CREDIT UNION

CONSENT ORDER, ETC. IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT AND THE FAIR CREDIT REPORTING ACT

Docket C-3146. Complaint, Oct. 17, 1984—Decision, Oct. 17, 1984

This consent order requires an Ann Arbor, Michigan credit union, among other things, to cease failing to disclose, when rejecting a credit application or increasing the cost of credit, that the action is based partially or wholly on information contained in a consumer credit report; and provide the rejected applicant with the name and address of the reporting agency together with the specific principal reason(s) for the adverse action based on this information. The Order also requires the credit union to send to consumers who were denied credit between January 1, 1983 and the effective date of the Order, a letter containing required disclosures.

Appearances

For the Commission: *George T. O'Brien.*

For the respondent: *Thomas J. O'Connor, Zweig & Harkness,* Southfield, Mich.

COMPLAINT

Pursuant to the provisions of the Fair Credit Reporting Act 15 U.S.C. 1681, *et seq.* and the Federal Trade Commission Act, 15 U.S.C. 41, *et seq.* and by virtue of the authority vested in it by said Acts, the Federal Trade Commission, having reason to believe that Hospital and Health Services Credit Union, a corporation, hereinafter referred to as respondent, has violated the provisions of said Acts, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint, stating its charges in that respect as follows:

PARAGRAPH 1. For the purposes of this complaint and the accompanying order the following definitions are applicable:

A. The terms *consumer, consumer report, consumer reporting agency* and *person* shall be defined as provided in section 603 of the Fair Credit Reporting Act, 15 U.S.C. 1681a.

B. The term *no file response* shall be defined as a consumer report consisting of a response by a consumer reporting agency to respondent's request for information on a given credit applicant indicating that the consumer reporting agency has no credit history information in its files under the name and other identifiers supplied by respondent.

C. The term *derogatory information* shall be defined as information in a consumer report furnished to respondent by a consumer reporting agency reflecting slowly paid or delinquent credit obligations, garnishment, attachment, foreclosure, repossession, bankruptcy, or suits or judgments.

D. The term *non-derogatory information* shall be defined as information in a consumer report, furnished to respondent by a consumer reporting agency, consisting of an insufficient number of accounts reported, the absence or presence of certain types of credit accounts, the presence of new credit accounts with credit histories too short to meet the respondent's criteria for granting credit or insufficient positive information to meet such criteria.

PAR. 2. Respondent is a corporation organized, existing and doing business under and by virtue of the laws of the State of Michigan with its principal office and place of business located at 959 Maiden Lane, Ann Arbor, Michigan. Respondent is a state chartered, federally insured credit union.

PAR. 3. Respondent, in the ordinary course and conduct of its business, uses information in consumer reports obtained from consumer reporting agencies in the evaluation of applications for credit to be used for personal, family or household purposes. In a substantial number of instances respondent denies credit applications from consumers applying for credit that they intend to use for personal, family or household purposes. The Commission has jurisdiction of the subject matter of this proceeding and of respondent, as provided by section 621 of the Fair Credit Reporting Act, 15 U.S.C. 1681s, and the Federal Trade Commission Act, 15 U.S.C. 41, *et seq.*

PAR. 4. Respondent, in the ordinary course and conduct of its business, obtains consumer reports from consumer reporting agencies. In a substantial number of instances subsequent to April 25, 1971, respondent has denied consumers credit for personal, family or household purposes based wholly or partly on derogatory or non-derogatory information contained in consumer reports, including an absence of sufficient favorable information contained in a consumer report or a "no file" response from the consumer reporting agency. In such instances, respondent has failed to disclose to the consumer at the time when such adverse action was communicated that the credit denial was based wholly or partly on information in a consumer report from a consumer reporting agency and to supply to the consumer the name and address of the consumer reporting agency making the report.

PAR. 5. By and through the use of the practices described in Paragraph Four, during the period from April 25, 1971 to the present respondent has violated and is violating the provisions of Section 615(a) of the Fair Credit Reporting Act, 15 U.S.C. 1681m(a).

PAR. 6. Respondent, in the ordinary course and conduct of its business, obtains information from persons other than consumer reporting agencies. Such persons include, but are not limited to, creditors listed as references on an application for consumer credit, as well as the landlord and the employer of the applicant. The information so obtained bears upon the consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics or mode of living. In a substantial number of instances subsequent to April 25, 1971, respondent has denied consumers credit for personal, family or household purposes based wholly or partly on such information obtained from such persons other than consumer reporting agencies. In these instances respondent has failed to disclose to the consumers at the time when adverse action was communicated, the fact that the credit was denied based wholly or partly on information obtained from a person other than a consumer reporting agency, and that they have the right to disclosure of the nature of such information upon written request.

PAR. 7. By and through the use of the practices described in Paragraph Six, during the period from April 25, 1971 to the present, respondent has violated and is violating section 615(b) of the Fair Credit Reporting Act, 15 U.S.C. 1681m(b).

PAR. 8. Pursuant to section 621(a) of the Fair Credit Reporting Act, 15 U.S.C. 1681s(a), the acts and practices set forth in this complaint as violations of the Fair Credit Reporting Act constitute unfair and deceptive acts and practices in or affecting commerce in violation of section 5 of the Federal Trade Commission Act, 15 U.S.C. 45.

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of complaint which the Bureau of Consumer Protection proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Fair Credit Reporting Act; and

The respondent, its attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondent has violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent Hospital and Health Services Credit Union is a corporation organized, existing and doing business under and by virtue of the laws of the State of Michigan, with its office and principal place of business located at 959 Maiden Lane, Ann Arbor, Michigan. Respondent is a state chartered, federally insured credit union.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

For the purposes of this Order, the following definitions are applicable:

A. The terms *consumer, consumer report, consumer reporting agency* and *person* shall be defined as provided in section 603 of the Fair Credit Reporting Act, 15 U.S.C. 1681a.

B. The term *no file response* shall be defined as a consumer report consisting of a response by a consumer reporting agency to respondent's request for information on a given credit applicant indicating that the consumer reporting agency has no credit history information in its files under the name and other identifiers supplied by respondent.

C. The term *derogatory information* shall be defined as information in a consumer report furnished to respondent by a consumer reporting agency reflecting slowly paid or delinquent credit obligations, garnishment, attachment, foreclosure, repossession, bankruptcy, or suits or judgments.

D. The term *non-derogatory information* shall be defined as information in a consumer report, furnished to respondent by a consumer reporting agency, consisting of an insufficient number of accounts reported, the absence or presence of certain types of credit accounts, the presence of new credit accounts with credit histories too short to meet the respondent's criteria for granting credit or insufficient positive information to meet such criteria.

It is ordered, That respondent Hospital and Health Services Credit Union, a corporation, its successors and assigns, and its officers, agents, representatives and employees, directly or through any corporation, subsidiary, division or other device, in connection with any application by a consumer for credit that is primarily for personal, family or household purposes, do forthwith cease and desist from:

1. Failing, whenever credit for personal, family or household purposes involving a consumer is denied wholly or partly or the charge for such credit is increased wholly or partly because of any derogatory or non-derogatory information contained in a consumer report from a consumer reporting agency (including insufficient positive information or a "no-file response"), to disclose to the applicant at the time the adverse action is communicated to the applicant, a) that the adverse action was based wholly or partly on information contained in such a consumer report and b) the name and address of the consumer reporting agency that made the report.

2. Failing, whenever credit for personal, family, or household purposes involving a consumer is denied wholly or partly or the charge for such credit is increased wholly or partly because of information obtained from a third person other than a consumer reporting agency bearing upon the applicant's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living, to disclose to the applicant at the time the adverse action is communicated to the applicant a) that the adverse action was based wholly or partly on information obtained from a third person other than a consumer reporting agency and b) either the nature of such information or the fact that the applicant has a right to learn the nature of such information, upon written request, in accordance with the provisions of Section 615(b) of the FCRA.

3. Failing to review each application for consumer credit for which it took adverse action between January 1, 1983, and the date of issuance of this Order, to identify each of those applications for which such adverse action was taken based wholly or partly upon information obtained from a consumer reporting agency or information obtained from a third person other than a consumer reporting agency bearing upon the applicant's credit-worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living.

4. Failing, within sixty (60) days of the date of issuance herein of

this Order, for each application identified according to paragraph 3 above, to send the applicant, as specified herein, a copy of the letter and notice attached hereto as appendices A and B and described herein. The letter shall bear the name and address of the applicant as shown on application, the date of mailing, and the name Hospital and Health Services Credit Union. No information other than that required by this paragraph shall be included in the letter or in the notice, nor shall any other material be sent to the applicant with the letter and notice. The letter and notice shall disclose:

(a) If the application that is the subject of the letter was denied wholly or partly because of information obtained from a consumer reporting agency, the name and address of that consumer reporting agency, together with the specific, principal reason(s) for the adverse action based on this information; and,

(b) if the application that is the subject of the letter was denied wholly or partly because of information obtained from any third party sources(s), the type of the sources(s) (*e.g.*, employer, bank, landlord), together with the specific, principal reason(s) for the adverse action based on this information from each source.

A letter and notice need not be sent to any applicant whose application was identified pursuant to paragraph 3 above, if the application file clearly shows that respondent Hospital and Health Services Credit Union has previously sent the applicant an adverse action notification in response to the application that complied in all respects with the provisions of paragraphs 1 and 2 of this Order.

It is further ordered, That respondent shall maintain for at least three (3) years and upon request make available to the Federal Trade Commission for inspection and copying documents that will demonstrate compliance with the requirements of this Order. Such documents shall include, but are not limited to, all credit evaluation criteria instructions given to employees regarding compliance with the provisions of this Order, any notices provided to consumers pursuant to any provisions of this Order and the complete application file to which they relate.

It is further ordered, That respondent shall notify the Federal Trade Commission at least thirty (30) days prior to any proposed change such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries, or any other change in the corporation that may affect compliance obligations arising out of the Order.

It is further ordered, That respondent shall deliver a copy of this Order to cease and desist to all present and future employees engaged in reviewing or evaluating consumer reports or other third party information in connection with applications for credit to be used for personal, family or household purposes, or engaged in preparing or furnishing notices to consumers as required by this Order.

It is further ordered, That respondent shall, within ninety (90) days after service upon it of this Order file with the Commission a report, in writing, setting forth in detail a full and complete description of how it has complied and is complying with the requirements of paragraphs 1, 2, 3 and 4 of this Order. Such report shall include, but is not limited to, a copy of each document used to instruct employees or agents of respondent regarding the requirements of these paragraphs, as well as a copy of each form letter used by respondent to comply with the requirements of these paragraphs and the number of applicants to whom the letter and notice required by paragraph 4 were mailed.

APPENDIX A

Dear ________:

According to our records, Hospital and Health Services Credit Union denied a credit application you submitted sometime after January 1, 1983. When we denied your application, we may not have told you the sources of information we relied upon, as federal law requires.[1]

Under a Consent Order with the Federal Trade Commission, we have agreed to review your application file and give you this information now. Our review shows that we obtained information relating to your creditworthiness from a consumer reporting agency or from one or more third party sources. Each source we relied upon is noted on the attached notice, along with our principal reason(s) for declining your application based on the information each one provided.

Sincerely,

Hospital and Health Services Credit Union

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[1] Whenever a creditor rejects a credit application, the Equal Credit Opportunity Act requires the creditor to tell the applicant the specific, principal reasons for its decision. The Fair Credit Reporting Act requires the creditor to tell the applicant whenever the reasons for its decision are based on information obtained from a credit reporting agency (such as a credit bureau) or from another third party (such as an employer). The Fair Credit Reporting Act also entitles the applicant to learn from the credit bureau what information is contained in his or her credit file and to learn from the creditor the nature of other third party information that the creditor relied on in rejecting the application.

APPENDIX B

NOTICE

I. If, in declining your application, we relied upon information obtained from a consumer reporting agency, the consumer reporting agency is identified below:

____
Name

____
Address

____

You have the right to contact the agency listed above to obtain complete informatio concerning your credit bureau file.

Based on the information obtained from this agency, we declined your application fo the following reason(s):

____

____

II. If, in declining your application, we relied upon information obtained from som third party source(s) other than a consumer reporting agency, we indicate below th source(s) of the information and the reason(s) it provided:

Source(s) **Reason(s) for Denial**

[ ] Your employer ______________________________

____

[ ] Your bank ______________________________

____

[ ] Your landlord ______________________________

[ ] Other________ ______________________________

____

IN THE MATTER OF

CHEVRON CORPORATION
and
GULF CORPORATION

CONSENT ORDER, ETC., IN REGARD TO ALLEGED VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 7 OF THE CLAYTON ACT

Docket C-3147. Complaint, Oct. 24, 1984—Decision, Oct. 24, 1984

This consent order requires Chevron Corporation (formerly the Standard Oil Company of California) to divest within six months to a Commission-approved buyer(s) all of the Gulf Corporation assets listed in Schedule A, as well as any additional assets and businesses that the company wishes to include as part of the assets to be divested, or which the Commission determines is necessary to ensure that the divested properties remain ongoing, viable business enterprises. Chevron is also required to provide petroleum product exchanges or crude oil supply arrangements to prospective acquirers, if necessary to maintain the properties as ongoing viable enterprises engaged in the same businesses in which they are presently employed; and to maintain all of Gulf's oil and gas assets as a separate, viable business in accordance with the terms of the attached Agreement To Hold Separate, until required divestiture has been completed. The companies are additionally prohibited from acquiring, without prior Commission approval, any interest in certain types of business enterprises located in specified geographic areas for a period of ten years.

Appearances

For the Commission: *Robert B. Greenbaum, Robert W. Doyle, Jr., Daniel P. Ducore, James M. Giffin* and *Joan L. Heim.*

For the respondents: *Charles B. Renfrew,* in-house counsel, San Francisco, Cal. for respondent Chevron Corp. and *Samuel W. Murphy, Jr.,* in-house counsel, Pittsburgh, Pa. for respondent Gulf Corp.

COMPLAINT

The Federal Trade Commission, having reason to believe that respondent, Chevron Corporation, a corporation subject to the jurisdiction of the Federal Trade Commission, has acquired the stock or assets of respondent Gulf Corporation, in violation of Section 7 of the Clayton Act, as amended (15 U.S.C. 18), and Section 5 of the Federal Trade Commission Act, as amended (15 U.S.C. 45), and that a proceeding in respect thereof would be in the public interest, hereby issues its complaint, pursuant to Section 11 of the Clayton Act (15 U.S.C. 21) and

Section 5(b) of the Federal Trade Commission Act (15 U.S.C. 45(b)), stating its charges as follows:

I. Definitions

1. For purposes of this complaint, the following definitions shall apply:

a. *Chevron* means Chevron Corporation, its predecessors, including Standard Oil Company of California, subsidiaries, divisions, groups, affiliate entities, and each of their past or present directors, officers, employees, agents and representatives; and each partnership, joint venture, joint stock company or concession in which Chevron is a participant. The words *subsidiary, affiliate* and *joint venture* refer to any partial (10 percent or more) as well as total ownership or control.

b. *Gulf* means Gulf Corporation, its predecessors, subsidiaries, divisions, groups, affiliate entities, and each of their past or present directors, officers, employees, agents and representatives; and each partnership, joint venture, joint stock company or concession in which Gulf is a participant. The words *subsidiary, affiliate* and *joint venture* refer to any partial (10 percent or more) as well as total ownership or control.

c. *The acquisition* means the transaction described, in whole or in part, in paragraph 14 of this Complaint.

d. *Gasoline* means motor gasoline as defined in connection with Department of Energy Form EIA-810, Monthly Refinery Report, product codes 132 and 133.

e. *Kerosene jet fuel* means kerosene-type jet aircraft fuel, as defined in connection with Form EIA-810, Monthly Refinery Report, product code 213.

f. *Fuel oil* means the products commonly known as number two fuel oil (home heating, diesel), as defined in connection with Department of Energy Form EIA-810, Monthly Refinery Report, product code 411.

g. *Terminal* means a facility used for receipt, storage, and distribution of gasoline, fuel oil, or kerosene jet fuel, and which receives product directly via pipeline, navigable waterway or from an adjacent refinery.

h. *Refined light products* means gasoline, fuel oil, kerosene jet fuel, and aviation gasoline.

i. *PADD* means Petroleum Administration for Defense District.

II. Respondents

A. *Chevron*

2. Respondent Chevron is a corporation organized and doing business under the laws of the state of Delaware with its executive offices at 225 Bush Street, San Francisco, California.

3. Respondent Chevron is a fully integrated petroleum company, engaged in the exploration for and production of crude oil and natural gas, refining, the transportation of crude oil, natural gas and refined products, and the distribution and marketing of refined products and natural gas.

4. In 1982, respondent Chevron had revenues of about $34 billion and assets of about $23 billion.

5. In 1982, respondent Chevron ranked seventh in the United States in crude oil production, seventh in domestic crude oil reserves, first in refining capacity, and seventh in gasoline sales.

6. Respondent Chevron has refineries located at Pascagoula, Mississippi; Perth Amboy, New Jersey; Baltimore, Maryland; El Paso, Texas; Salt Lake City, Utah; Richmond, California; El Segundo, California; Kenai, Alaska; Bakersfield, California; Honolulu, Hawaii; Willbridge, Oregon; and Seattle, Washington, with a combined refining capacity of 1381 thousand barrels per day.

7. At all times relevant herein, respondent Chevron has been and is now engaged in commerce as "commerce" is defined in Section 1 of the Clayton Act, as amended, 15 U.S.C. 12, and is a corporation whose business is in or affecting commerce as "commerce" is defined in Section 4 of the Federal Trade Commission Act, as amended, 15 U.S.C. 44.

B. *Gulf*

8. Respondent Gulf is a corporation organized and doing business under the laws of the state of Delaware with its executive offices at Pittsburgh, Pennsylvania.

9. Respondent Gulf is a fully integrated petroleum company, engaged in the exploration for and production of crude oil and natural gas, refining, the transportation of crude oil, natural gas and refined products, and the distribution and marketing of refined products and natural gas.

10. In 1982, respondent Gulf had revenues of about $28 billion and assets of about $20 billion.

11. In 1982, respondent Gulf ranked eighth nationally in crude oil production, tenth in United States crude oil reserves, seventh in Unit-

ed States refining capacity, and sixth in United States motor gasoline sales.

12. Respondent Gulf has refineries located at Port Arthur, Texas; Alliance, Louisiana; Philadelphia, Pennsylvania; and Cincinnati, Ohio, with a combined refining capacity of about 829 thousand barrels per day.

13. At all times relevant herein, respondent Gulf has been and is now engaged in commerce as "commerce" is defined in Section 1 of the Clayton Act, as amended, 15 U.S.C. 12, and is a corporation whose business is in or affecting commerce as "commerce" is defined in Section 4 of the Federal Trade Commission Act, as amended, 15 U.S.C. 44.

III. The Acquisition

14. On or about March 7, 1984, Chevron, whose corporate name was Standard Oil Company of California ("Socal") prior to July 1, 1984, commenced a cash tender offer for up to 100 percent of the outstanding shares of Gulf common stock at a price of $80 per share with the intent of effecting a merger of Socal Acquisition Corporation, a Delaware corporation wholly-owned by Chevron, into Gulf, pursuant to which Gulf would become a wholly-owned subsidiary of Chevron, all as contemplated in that certain merger Agreement entered into among Chevron, its subsidiary, and Gulf, on March 5, 1984. Gulf's Board of Directors approved the tender offer and recommended its acceptance by Gulf shareholders. On April 26, 1984, Chevron began purchasing Gulf shares pursuant to the tender offer. On May 4, the tender offer expired. By such date, Chevron had purchased approximately 82 percent of Gulf's outstanding shares. Subsequently, Chevron contributed the Gulf shares purchased by it to Socal Acquisition Corporation and on June 15 that corporation was merged into Gulf Corporation. In the course of such merger, all outstanding Gulf shares were canceled, with the shares not held by Socal Acquisition Corporation being converted into a right to receive $80 cash per share. The total value of the transaction is about $13.2 billion, resulting in the second largest petroleum company and the second largest industrial corporation in the United States in terms of assets.

IV. Trade and Commerce

A. *Kerosene Jet Fuel*

15. One relevant line of commerce in which to evaluate the effects

of the acquisition is the manufacture and distribution of kerosene jet fuel.

16. One relevant section of the country is PADDs I and III combined (excluding New Mexico and the following counties in the state of Texas: Hansford, Hutchinson, Carson, Armstrong, Briscoe, Floyd, Crosby, Carza, Borden, Howard, Glassock, Reagan, Crockett, Terrell, and all counties west thereof) and the West Indies and Caribbean Islands.

17. The kerosene jet fuel markets described in paragraphs 15 and 16 are concentrated.

18. Conditions of entry into the manufacture of jet fuel in the relevant section of the country are difficult.

19. Chevron and Gulf are direct and substantial competitors in the manufacture and sale of jet fuel in the relevant sections of the country. Chevron makes kerosene jet fuel at its refinery at Pascagoula, Mississippi. Gulf makes kerosene jet fuel at its refineries at Port Arthur, Texas; Alliance, Louisiana; and Philadelphia, Pennsylvania.

B. *Transportation of Refined Light Products*

20. One relevant line of commerce in which to evaluate the effects of the acquisition is the business of transporting refined light petroleum products from refineries into consuming regions. Within this market, petroleum product pipelines represent another relevant line of commerce.

21. One relevant section of the country is the inland Southeast region composed of portions of Mississippi, Alabama, Georgia, Tennessee, South Carolina, North Carolina and of Virginia.

22. Transportation of refined light petroleum products into the inland Southeast is highly concentrated.

23. Conditions of entry into the business of the transporting refined light products by pipeline into the inland Southeast are difficult.

24. Colonial and Plantation are direct competitors in the business of transporting refined light products by pipeline into the inland Southeast.

25. Gulf owns the largest ownership share of Colonial (16.78 percent).

26. Chevron owns the second largest ownership share of Plantation (27.13 percent).

27. Because Gulf owns a share of Colonial and Chevron owns a share of Plantation, Chevron and Gulf are direct and substantial competitors in the business of transporting refined light product by pipeline into the inland Southeast.

C. *Marketing of Gasoline and Middle Distillate*

28. Another relevant line of commerce in which to evaluate the effects of the acquisition is the wholesale distribution of gasoline and middle distillate and submarkets thereof.

29. The relevant sections of the country are the areas served by terminal clusters in or near the following cities and areas:

a. Louisville, Kentucky;
b. Huntington, West Virginia; Ashland, Kentucky (combined);
c. Paducah, Kentucky;
d. Knoxville, Tennessee;
e. Chattanooga, Tennessee;
f. Meridian, Mississippi;
g. Collins, Mississippi;
h. Mobile, Alabama; Biloxi, Gulfport, Pascagoula, Moss Point, Mississippi; Pensacola, Florida (combined);
i. Montgomery, Alabama;
j. Birmingham, Gadsden, Anniston, Tuscaloosa, Alabama (combined);
k. Atlanta, Georgia;
l. Athens, Georgia
m. Macon, Georgia;
n. Greenville, Spartanburg, South Carolina (combined);
o. Jacksonville, Gainesville, Florida (combined);
p. Tampa, St. Petersburg, Bradenton, Sarasota, Ft. Meyers, Lakeland, Winterhaven, Florida (combined);
q. Miami, Ft. Lauderdale, West Palm Beach, Florida (combined).

30. The wholesale gasoline and fuel oil markets described in paragraphs 28 and 29 are concentrated.

31. Conditions of entry into the wholesale distribution of gasoline and fuel oil are difficult.

32. Respondents Chevron and Gulf are direct and substantial competitors in the wholesale distribution of gasoline and fuel oil in the relevant sections of the country.

D. *Transportation of Crude Oil*

33. One relevant line of commerce in which to evaluate the effects of the acquisition is the transportation of crude oil from producing fields to refineries.

34. One relevant section of the country is the West Texas/New Mexico region, composed of "producing districts 8, 8A and 7C" as defined by the Texas Railroad Commission and "New Mexico-East" as defined by the U.S. Department of Energy.

35. Refinery capacity in the West Texas/New Mexico region is substantially below production in the area, with the result that much production in the area is transported over long distances to refineries on the Gulf Coast and in the midcontinent area.

36. The business of transporting crude oil by pipeline out of West Texas/New Mexico is concentrated.

37. Conditions of entry into the business of the transportation of crude oil by pipeline out of the West Texas/New Mexico region are difficult.

38. Chevron is the sole owner of a 20 inch diameter pipeline that runs from the West Texas/New Mexico producing area to El Paso, Texas and supplies crude oil to the Chevron refinery and the Texaco refinery at El Paso.

39. Gulf is the largest owner of stock in the West Texas Gulf Pipeline Company and therefore controls the West Texas Gulf Pipeline, a 26 inch and 20 inch diameter pipeline that connects the West Texas/New Mexico producing area with both the Gulf Coast and the Mid-Valley Pipeline at Longview, Texas.

40. Respondents Chevron and Gulf are direct and substantial competitors in the business of transporting crude oil by pipeline out of the West Texas/New Mexico region.

V. Effects

41. The effect of the acquisition may be substantially to lessen competition or tend to create a monopoly in each of the relevant lines of commerce and relevant sections of the country in violation of Section 7 of the Clayton Act, as amended, 15 U.S.C. 18, and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. 45, in the following ways, among others:

a. actual competition between respondents Chevron and Gulf in the relevant lines of commerce and relevant sections of the country will be eliminated;

b. actual competition between competitors generally in the relevant lines of commerce and relevant sections of the country will be lessened;

c. concentrations in the relevant lines of commerce and relevant sections of the country will be increased, therefore increasing the likelihood of collusion; and

d. coordination between existing competitors in the relevant lines of commerce and relevant sections of the country will be increased, therefore increasing the likelihood of collusion.

VI. Violation Charged

42. The proposed acquisition of the stock and assets of Gulf by Chevron, as set forth in paragraph 14 herein, if consummated, would violate Section 7 of the Clayton Act, as amended, 15 U.S.C. 18, and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. 45.

DECISION AND ORDER

The FTC having initiated an investigation of the proposed acquisition of shares of Gulf Corporation ("Gulf") by Standard Oil of California ("Chevron") and Chevron and Gulf ("respondents") having been furnished with a copy of a draft of complaint that the Bureau of Competition proposed to present to the Commission for its consideration, and which, if issued by the Commission would charge respondents with violations of the Clayton Act and Federal Trade Commission Act; and

Respondents, their attorneys, and counsel for the Commission having thereafter executed an agreement containing a consent order, and admission by respondents of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondents that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having considered the matter and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, and having duly considered the comments filed thereafter by interested persons pursuant to Section 2.34 of its Rules and the recommendation of its staff, and having concluded that the consent agreement should be accepted with modifications, including Chevron's July 1, 1984 change in its corporate name to "Chevron Corporation"; and

Respondents having thereafter agreed by letter to these modifications in the consent agreement; and

Now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent Chevron Corporation is a corporation organized, existing and doing business under and by the virtue of the laws of Delaware with its executive office located at 225 Bush Street, San Francisco, California.

Respondent Gulf Corporation, a wholly owned subsidiary of Chevron, is a corporation organized and doing business under and by virtue of the laws of Delaware, with its executive office located at the Gulf Building, Pittsburgh, Pennsylvania.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondents, and the proceeding is in the public interest.

ORDER

I.

As used in this order the following definitions shall apply:

(a) *Acquisition* means Chevron's acquisition of shares of the Common Stock of Gulf.

(b) *Oil and gas assets and businesses* means all Gulf's domestic crude oil and gas, and assets and operations relating to oil and gas exploration, production and transportation, as well as petroleum and petrochemical processing, refining, transportation and marketing activities, and any similar foreign activities to the extent involved in imports into the United States.

(c) *Schedule A Properties* means the assets and businesses listed in Schedule A of this agreement.

(d) *Gulf* means Gulf Corporation, as it was constituted prior to the acquisition, including its parents, predecessors, subsidiaries, divisions, groups and affiliates controlled by Gulf and their respective directors, officers, employees, agents and representatives and their respective successors and assigns.

(e) *Chevron* means Chevron Corporation, its predecessors, including Standard Oil Company of California, subsidiaries, divisions, groups and affiliates controlled by Chevron and their respective directors, officers, employees, agents and representatives, and their respective successors and assigns.

(f) *Wholesale distribution of gasolines and middle distillates* includes but is not limited to terminals, bulk plants, warehouses, and package plants.

(g) *Marketing* includes but is not limited to the properties described in paragraph (f) above, together with tank trucks, service station properties, and product inventories.

II.

It is ordered, That:

(A) Chevron shall divest, absolutely and in good faith, within six months from the date this order becomes final, the Schedule A Properties, as well as any additional oil and gas assets and businesses relating to oil and gas transportation, and petroleum and petrochemical processing, refining, transportation, and marketing that (i) Chevron may at its discretion include as a part of the assets to be divested and are acceptable to the acquirer, or (ii) the Commission shall require to be divested to ensure the divestiture of the Schedule A Properties as ongoing, viable enterprises, engaged in the businesses in which the Properties are presently employed.

(B) Chevron shall provide prospective acquirers of the Schedule A Properties petroleum product exchanges, crude oil supply arrangements, or equity crude oil arrangements if necessary to ensure divestiture of the Properties as ongoing viable enterprises engaged in the same businesses in which the Properties are presently employed.

(C) The Agreement to Hold Separate, attached hereto and made a part hereof as Appendix I, shall continue in effect until such time as the Schedule A Properties have been divested, and Chevron and Gulf shall comply with all terms of said Agreement.

(D) Divestiture of the Schedule A Properties shall be made only to a buyer or buyers, and only in a manner, that receives the prior approval of the Commission. The purpose of the divestiture of the Schedule A Properties is to ensure the continuation of the assets as ongoing, viable enterprises engaged in the same businesses in which the Properties are presently employed and to remedy the lessening of competition resulting from the Acquisition as alleged in the Commission's complaint.

(E) Chevron and Gulf shall maintain the viability and marketability of the Schedule A Properties and shall not cause or permit the destruction, removal or impairment of any assets or businesses to be divested except in the ordinary course of business and except for ordinary wear and tear.

III.

It is further ordered, That, within sixty days after the date of service of this order, and every sixty days thereafter until Chevron has fully complied with the provisions of paragraph II of this order, Chevron shall submit to the Commission a verified written report setting forth in detail the manner and form in which it intends to comply, is complying with, or has complied with that provision. Chevron shall include in compliance reports, among other things that are required from time to time, a full description of contacts or negotiations for the divestiture of properties specified in paragraph II of this order, including the identity of all parties contacted. Chevron also shall include in its compliance reports copies of all written communications to and from such parties, and all internal memoranda, reports and recommendations concerning divestiture.

IV.

It is further ordered, That for a period commencing on the date of service of this order and continuing for ten years from and after the date of service of this order, Chevron shall cease and desist from acquiring, without the prior approval of the Federal Trade Commission, directly or indirectly, through subsidiaries or otherwise, assets used or previously used in (and still suitable for use in), or any interest in, or the whole or any part of the stock or share capital of, any company that is engaged in refining, the wholesale distribution of gasolines or middle distillates, or pipeline transportation, in Tennessee, Kentucky, PAD Districts I or III, or the West Indies, including the Bahamas and the Caribbean Islands; *provided, however,* that, except for the Borco refinery, these prohibitions shall not relate to the construction of new facilities or participation in joint ventures in which Chevron is a participant on the date of service of the order.

One year from the date of service of this order and annually thereafter Chevron shall file with the Commission a verified written report of its compliance with this paragraph.

V.

For the purposes of determining or securing compliance with this order, and subject to any legally recognized privilege, upon written request and on reasonable notice to Chevron or Gulf made to its principal office, Chevron and Gulf shall permit any duly authorized representatives of the Commission:

1. Access, during office hours and in the presence of counsel, to inspect and copy all books, ledgers, accounts, correspondence, memoranda and other records and documents in the possession or under the control of Chevron or Gulf relating to any matters contained in this order; and

2. Upon five days' notice to Chevron or Gulf and without restraint or interference from them, to interview officers or employees of Chevron or Gulf, who may have counsel present, regarding such matters.

VI.

It is further ordered, That Chevron notify the Commission at least thirty days prior to any change in the corporation such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change that may affect compliance obligations arising out of the order.

SCHEDULE A

Assets to be divested as provided above are the following:

1. All of Gulf's marketing assets, including the Gulf brand name and trademark, located in the States of Kentucky, Tennessee, Alabama, Mississippi, Georgia and Florida, and the area of South Carolina served by Gulf's Spartanburg, South Carolina terminal and either the Port Arthur or Alliance refinery, including all associated on-site facilities and dedicated pipelines and terminals. (Chevron may elect to divest either refinery, provided that the divestiture of that particular refinery is approved by the Commission).

2. Gulf's stock interest in Colonial pipeline.

3. a. If Chevron divests the Port Arthur refinery, then along with the paragraph 1 assets of this Schedule, 51 percent of Gulf's interest in (i) the West Texas Gulf Pipeline Company, (ii) the Mesa Pipeline, and (iii) any other pipeline attached to the West Texas Gulf or Mesa pipelines.

b. If Chevron divests the Alliance refinery, then 51 percent of Gulf's interest in the West Texas Gulf Pipeline Company.

ATTACHMENT I

UNITED STATES OF AMERICA
BEFORE FEDERAL TRADE COMMISSION

In the Matter of
STANDARD OIL COMPANY OF CALIFORNIA,
a corporation,

and

GULF CORPORATION,
a corporation.

File No. 841-0109

AGREEMENT TO HOLD SEPARATE

Agreement dated as of April 26, 1984 (the "Agreement"), by and between Standard Oil Company of California ("Socal"), a corporation organized and existing under the laws of Delaware, whose executive offices are located at 225 Bush Street, San Francisco, California 94104, Gulf Corporation ("Gulf"), a corporation organized and existing under the laws of Delaware, whose executive offices are located at the Gulf Building, Pittsburgh, Pennsylvania 15320, and the Federal Trade Commission ("the Commission"), an independent agency of the United States Government, established under the Federal Trade Commission Act of 1914, 15 U.S.C. section 41, et seq. (collectively, the "Parties").

PREMISES

Whereas, Social commenced on March 7, 1984, a tender offer for all of the outstanding shares of Common Stock of Gulf Corporation, a Delaware corporation ("Gulf"), with the intent of effecting a merger of Socal Acquisition Corporation, a Delaware corporation wholly owned by Socal ("Subsidiary"), into Gulf, pursuant to which Gulf would become a wholly owned subsidiary of Socal, all as contemplated and provided for in that certain Merger Agreement entered into among Socal, Subsidiary and Gulf on March 5, 1984 (the "Merger Agreement"); and

Whereas, simultaneously with the execution of the Merger Agreement, on March 5, 1984, Socal and Gulf also entered into a Stock Option Agreement (the "Stock Option Agreement") pursuant to which Gulf granted Socal an option to purchase 30,500,000 authorized but unissued shares of Gulf's Common Stock, constituting approximately 15.6 percent of the shares of Gulf's Common Stock that would be outstanding after such issuance; and

Whereas, the Commission is now investigating the transactions contemplated by the Merger Agreement and the Stock Option Agreement (which transactions are hereinafter referred to as the "Acquisition") to determine if the Acquisition would violate any of the statutes enforced by the Commission; and

Whereas, if the Commission accepts the attached Agreement Containing Consent Order ("Consent Order") the Commission must place it on the public record for a period of at least sixty days and may subsequently withdraw such acceptance pursuant to the provisions of section 2.34 of the Commission's Rules; and

Whereas, the Commission is concerned that if an understanding is not reached preserving the status quo ante of Gulf's oil and gas assets and businesses during the period prior to the divestiture of the properties described on Schedule A of the Consent Order ("Schedule A Properties") along with such other assets as may be required under paragraph II of the Consent Order, or the Acquisition is not preliminarily enjoined, divestiture resulting from any proceeding challenging the legality of the Acquisition might not be possible or might be a less than effective remedy; and

Whereas, the Commission is concerned that if the Acquisition is consummated, it will be necessary to preserve the Commission's ability to require the divestiture of properties described in paragraph II of the Consent Order in addition to the Schedule A Properties, and the Commission's rights to seek to restore Gulf as a viable competitor.

Whereas, the purpose of this Agreement and the Consent Order is to preserve Gulf as a viable, integrated petroleum company pending the divestiture of the Schedule A Properties as viable, ongoing enterprises, in order to remedy any anticompetitive effects of the Acquisition and to preserve Gulf as a viable, integrated petroleum company in the event that divestiture is not achieved; and

Whereas, Socal's and Gulf's entering into this Agreement shall in no way be construed as an admission by Socal or Gulf that the Acquisition is illegal; and

Whereas, Socal and Gulf understand that no act or transaction contemplated by this Agreement shall be deemed immune or exempt from the provisions of the antitrust laws or the Federal Trade Commission Act by reason of anything contained in this Agreement.

Now, therefore, the Parties agree, upon the understanding that the Commission has not yet determined whether the Acquisition will be challenged, and in consideration of the Commission's agreement that, unless the Commission determines to reject the Consent Order, it will not seek further relief from Socal with respect to the Acquisition, except that the Commission may exercise any and all rights to enforce this Agreement and the Consent Order to which it is annexed and made a part thereof, and in the event the required divestitures are not accomplished, to seek divestiture of all Gulf's oil and gas assets and businesses held separate pursuant to this Agreement, as follows:

1. Socal and Gulf agree to execute and be bound by the attached Consent Order.

2. Socal agrees that, until (i) three business days after the Commission withdraws its acceptance of the Consent Order pursuant to the provisions of section 2.34 of the Commission's Rules; or (ii) if the Commission within 120 days after publication in the *Federal Register* of the Consent Order finally accepts such order, until all of the divestitures required by Schedule A of the Consent Order are approved by the Commission, Socal will hold Gulf's oil and gas assets and businesses, as defined in 2(a), separate and apart on the following terms and conditions:

a. All Gulf's domestic crude oil and gas assets and operations relating to domestic crude oil and gas exploration and production, and transportation as well as petroleum and petrochemical processing, refining, transportation and marketing activities, and any similar foreign activities to the extent involved in imports into the United States ("oil and gas assets and businesses") shall be operated independently of Socal.

b. Socal shall not exercise direction or control over, or influence directly or indirectly, any of Gulf's oil and gas assets and businesses; *provided, however,* that Socal may exercise only such direction and control over Gulf as is necessary to assure compliance with this Agreement.

c. Except as required by law and except to the extent that necessary information is exchanged in the course of evaluating the Acquisition, defending litigation, or negotiating agreements to dispose of assets, Socal shall not receive or have access to, or the use of, any "material confidential information" relating to Gulf's oil and gas assets and businesses not in the public domain, except as such information would be available to Socal in the normal course of business if the Acquisition had not taken place. Any such information that is obtained pursuant to this subparagraph shall only be used for the purposes set out in this subparagraph. ("Material confidential information" as used herein means competitively sensitive or proprietary information not independently known to Socal from sources other than Gulf and includes, but is not limited to, customer lists, price lists, marketing methods, geological and geophysical data, patents, technologies, processes or other trade secrets.)

d. Socal shall not change the composition of the management of Gulf's oil and gas assets and businesses except that the current Gulf directors serving on the "New Board" (as defined in paragraph f) shall have the power to remove employees for cause; Socal shall maintain the viability and marketability of Gulf's oil and gas assets and businesses and shall not sell, transfer, encumber, or otherwise impair their marketability or viability (other than in the normal course of business or pursuant to paragraph h).

e. All material transactions, out of the ordinary course of business and not precluded by paragraph 2(a)-(d), shall be subject to a majority vote of the New Board (as defined in paragraph f).

f. Socal may adopt new articles of incorporation and by-laws (provided that they are not inconsistent with other provisions of this Agreement) and may elect a new Board of Directors of Gulf ("New Board") once it is a majority shareholder of Gulf. Socal may elect any number of directors to the Board; *provided, however,* that such Board shall consist of at least six current Gulf directors and no more than two Socal directors, officers, employees, or agents. Except as permitted by this agreement, the directors of

Gulf who are also Socal directors, officers, employees or agents, shall not receive in their capacity as directors of Gulf material confidential information relating to Gulf's oil and gas assets and businesses and shall not disclose any such information they may receive under this agreement to Socal or use it to obtain any advantage for Socal. Said Directors of Gulf who are also Socal directors, officers, employees, or agents, shall enter a confidentiality agreement prohibiting disclosures of confidential information. Such directors shall participate in matters which come before the New Board only for the limited purpose of considering a capital investment or other transactions exceeding $50,000,000 and carrying out Socal's and Gulf's responsibility to assure that the Schedule A Properties and such other properties as the Commission may elect to add under paragraph II of the Consent Order are maintained in such manner as will permit their divestiture as ongoing, viable assets. Except as permitted by this agreement, such directors shall not participate in any matter, or attempt to influence the votes of the other directors with respect to matters that would involve a conflict of interest if Socal and Gulf were separate independent entities. Meetings of the board during the term of this Agreement shall be stenographically transcribed and the transcripts retained until two years after the termination of this Agreement.

g. The New Board may transfer the properties described in Schedule A of the Consent Order ("Schedule A Properties") into a wholly owned Gulf subsidiary or division.

h. Nothing herein shall prevent the current Gulf Board or the New Board from negotiating or entering into agreements to dispose of Gulf's assets, provided that any such agreements with respect to oil and gas related assets and businesses are conditioned on and not consummated prior to final approval by the Commission.

i. Nothing contained in this Agreement shall be construed to limit the sale of Gulf's nonpetroleum related assets by majority vote of the full current Gulf Board or New Board. Socal shall have the right to borrow all proceeds from any such sale in exchange for an interest bearing note (calculated at the General Motors Acceptance Corporation short term thirty day rate) made payable to Gulf and falling due fourteen days after any denial of final approval of the Consent Order by the Commission.

j. A majority of the New Board may declare a dividend and payment no greater than the amount paid in the same quarter in 1983. Except for such dividend payment, all earnings and profits of Gulf shall be retained separately in Gulf. Socal shall have the right to borrow monies from Gulf upon approval by the majority of the New Board on the same terms and conditions as described in paragraph (i); *provided, however,* Socal shall not borrow funds if the result would be to impair Gulf's ability to operate its oil and gas assets and businesses at its 1983 levels of expenditure on an annualized basis.

k. Should the Federal Trade Commission seek in any proceeding to compel Socal to divest itself of the shares of Gulf Common Stock it shall acquire, or to compel Socal or Gulf to divest themselves of any oil and gas assets that may be held by either company, or to seek any other injunctive or equitable relief, neither Socal nor Gulf shall raise an objection based upon the expiration of the applicable Hart-Scott-Rodino Antitrust Improvements Act waiting periods or the fact that the Commission has permitted the Gulf Common Stock to be acquired and a formal merger concluded pursuant to the terms of this Agreement. Socal and Gulf also waive all rights to contest the validity of this Agreement.

3. For the purpose of determining or securing compliance with this Agreement, subject to any legally recognized privilege, and upon written request with reasonable notice to Socal or Gulf made to its principal office, Socal and Gulf shall permit any duly authorized representative or representatives of the Commission:

a. Access during the office hours of Socal or Gulf, in the presence of counsel, to inspect and copy all books, ledgers, accounts, correspondence, memoranda and other records and documents in the possession or under the control of Socal or Gulf relating to compliance with this agreement.

b. Upon five days notice to Socal or Gulf and without restraint or interference from them, to interview officers or employees of Socal or Gulf, who may have counsel present, regarding any such matters.

No information or documents obtained by the Commission shall be divulged by any representative of the Commission, except in the case of legal proceedings to which the Commission is a party, or for the purposes of securing compliance with this Consent Order, or as otherwise required by law.

If, at any time information or documents are furnished by Socal and Gulf and Socal or Gulf identify same as "Confidential," then the Commission shall provide to Socal and Gulf ten days notice or, if ten days is not possible, as many days notice as possible prior to divulging such material in any legal proceeding to which that entity is not a party.

4. This Agreement shall not be binding until approved by the Commission.

/s/John H. Carley
General Counsel
Federal Trade Commission
Washington, D.C. 20580

/s/Charles B. Renfrew
Director and Vice President, Legal
Standard Oil Company of California
225 Bush Street
San Francisco, California 94104

/s/Samuel W. Murphy, Jr.
Senior Vice President and General Counsel
Gulf Corporation

DISSENTING STATEMENT OF COMMISSIONER MICHAEL PERTSCHUK

I find the decision on this consent agreement to be a far closer question than the *Texaco-Getty* consent agreement or the failure of the Commission to pursue an adequate remedy in the *Mobil-Marathon* case, primarily because the staff has negotiated an agreement which gives some hope that the divested Gulf properties will emerge in an economically viable and competitive posture. For this, credit must be given to the skill and determination of key staff members as well as to the healthy expressions of concerns about past Commission actions by those outside the Commission. Yet I find myself compelled to vote against the agreement and in favor of seeking to enjoin the merger for a number of reasons.

First, it has become increasingly obvious that there are major weaknesses in our procedures for addressing the antitrust problems of huge mergers in a limited period of time and for negotiating massive and complex divestitures. Under the terms of the Hart-Scott-Rodino Act, we have as little as ten days before the Commission must decide whether to challenge a merger after requested information is received from the merging companies. In this case, the largest merger in history, the staff analysis of the consent agreement—the principal document describing the consent agreement and its rationale—was provided to the Commission at about 2:00 P.M yesterday, Bureau of Economic analyses on key points arrived at 6:00 P.M., and the Bureau Director's memo was furnished at 6:30 P.M. These memos deal with exceedingly complex issues of restructuring Gulf assets and attempting to solve major horizontal overlaps in a series of markets. I do not believe that a responsible evaluation of these issues can be done, including resolving the competing claims of various staff and interested private groups, in the few hours available.

Second, although the consent agreement represents a major improvement over our approach in *Texaco-Getty,* I am still concerned that the divestitures we have in mind risk the selling off and eventual demise of assets which have up till now been viable. A major advantage of this agreement is that it provides for holding Gulf separate until the divestitures are approved and, more importantly, for providing the Commission authority to order *additional* divestitures, including crude oil, to insure the divested assets are continued as "ongoing, viable enterprises." This provision, as well as the staff analysis, recognize the crucial importance of access to crude oil in maintaining viability for refiners and marketers. It is a principle we could have put to better use in the *Texaco-Getty* and *Mobil-Marathon* matters.

However, this hold separate agreement is not the ordinary hold separate procedure employed to preserve the Commission's opportunity to enjoin a merger entirely after a period of investigation or litigation. This hold separate provision is a lever to encourage Socal to divest properties as well as a way of facilitating sale of assets in viable "packages," but it is not a guarantee to the Commission that it can conclude later that the only way the assets can be viable is that the merger itself be rescinded.

The staff candidly admits that "despite the strong guarantees in the consent a refinery-marketing divestiture is not without risks." These risks arise because of the importance of regular access to crude and refined products as well as the powerful incentive Socal has to sell off or close down the least desirable properties it acquires from Gulf. In order to insure that the divested properties remain viable, the Commission will have to oversee complex negotiations between Socal and potential buyers, to make predictions about what the buyers intend to do with purchased assets, and to determine what additional assets, particularly crude supply contracts, are necessary for "viability." As far as I know, the Commission has never assumed responsibility for overseeing such a major restructuring of assets, and it remains to be seen how effective and vigorous it will be in carrying out this difficult job over the coming months.

At the very least, we can expect temporary supply contracts of one sort or another to be negotiated as a part of these sales. Are Socal temporary supply agreements sufficient to get a refinery or marketing assets permanently over some survival threshold, or will they be temporary lifelines only? Further, will such supply contracts in reality be agreed to by potential buyers because they are able to get crude oil at a bargain price, not because they actually intend to operate assets for the long term? Moreover, if this complex divestiture plan begins to fall apart some months from now, what are the Commission's options? As I interpret the agreement, we do have a fair amount of discretion in requiring Socal to put additional assets in divestiture package, but we do *not* have the discretion to throw up our hands and say the only solution is preserving an independent Gulf. By accepting this agreement we are committed to a course in which most of Gulf is absorbed by Socal and some of its least desirable assets are parceled out. There will be no turning back from that basic decision.

I realize that there are limits to how certain we can be about the success of divestitures, but I do not believe the law requires us to take any significant risks once a merger has been recognized as a likely violation of the law. All the Commissioners agree that this merger is likely to harm competition and violate the antitrust laws; otherwise there would be no need for a consent agreement. The question is what degree of risk that our remedies are insufficient are we to assume. In answering that question, it is reasonable to ask: what are the social benefits of this merger? It is fairly clear that there are no significant "efficiencies" in any ordinary use of the word. While Socal argues that acquiring Gulf will give Socal access to Gulf's technology, few specifics are offered, and Socal's president conceded that Socal can acquire industry technology in other ways. In a survey of possible acquisitions, Socal could not identify synergies with Gulf's upstream assets. Socal's principal basis for any future cost savings appears to be closing down facilities. Based on this and other evidence, the staff concludes that "this acquisition does not present the efficiencies which might have flowed from several earlier mergers in this industry, notwithstanding Socal's statements that it does." In short, I believe the Commission is accepting substantial risks in relying on a complex, uncertain remedy in a case where a merger clearly appears to be unlawful, and offers few, if any, benefits other than to the private parties.

Other Provisions

I am also troubled by a number of other provisions and omissions in the agreement. For example, the agreement provides an option to Socal to divest one of Gulf's two refineries in the Gulf Coast area. Depending on which refinery Socal chooses, the Herfindahl index would still increase about 100 points in kerojet production (less in the case of a divestiture of Port Arthur, more if Alliance is sold). Second, the staff identified an overlap in the sale of aviation gasoline in the Gulf and East coast regions that would exceed the Justice guidelines in increasing the Herfindahl index, but did not address it in the agreement. Each of these issues alone would not justify rejecting the entire agreement but, taken together with the considerations mentioned above, they strengthen the argument against it.

Non-Antitrust Issues

However close the antitrust issues are here, and I believe they are closer than in some previous cases on which I disagreed with the majority, we should keep in mind that issues we cannot address under the antitrust laws remain of major, perhaps overriding, importance. This merger is driven by Socal's desire for crude oil. Despite protestations to the contrary by company officials, I find it very difficult to conclude that this merger will not diminish exploration for crude oil. One major company, which has needed additional crude reserves, has now disappeared. A second major competitor, which has had strong incentives to drill, has now won control of 2 billion barrels of crude oil reserves along with a huge debt burden. We may not understand precisely how much this acquisition will reduce exploration but to assume it will affect it little or none at all flies in the face of common sense.

Conclusion

Even though I believe staff has done a commendable job in negotiating this agreement under severe time constraints, in particular, by giving the Commission a greater ability to insure the divestitures achieve their stated purpose, I cannot help but conclude that there are too many unanswered questions and too many risks to endorse this agreement. The law does not require that we go out of our way to restructure acquisitions that violate the antitrust laws, particularly when there is a cloud of uncertainty as to whether our restructuring will or will not work and when the merger, which we are struggling so hard to preserve, offers no significant efficiencies. While the public comment period on this case can be particularly useful, because of the scope and significance of the acquisition and divestitures, I must vote against the agreement based on what has been presented to the Commission.

STATEMENT OF COMMISSIONER PATRICIA P. BAILEY

The hold separate and consent agreements tentatively accepted by the Commission in this matter to my mind propose solutions to the measurable, or even reasonably foreseeable anticompetitive consequences of this merger. Substantial divestitures have been ordered, and even additional divestiture and contract relief is also available under these agreements, if necessary to facilitate sale of these assets and insure their continuation as competitively viable entities.

Any calculated risk that the relief proposed will not result in the creation of viable new competitive forces in refining and marketing is reduced by a novel requirement that SoCal keep Gulf's domestic petroleum assets as an independent entity until all divestitures acceptable to the Commission have been actually achieved. This means that the Commission maintains substantial legal leverage to insure SoCal's incentive to divest, in accord with the procompetitive intentions implicit in the Commission's order. I believe that this feature of the relief in this matter will ensure that the Commission can continue to act in the best interests of the public during the divestiture phase of this difficult case.

IN THE MATTER OF

AMERICAN MEDICAL INTERNATIONAL, INC., ET AL.

MODIFYING ORDER, ETC., IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 7 OF THE CLAYTON ACT

Docket 9158. Final Order, July 2, 1984—Modified Order, Nov. 9, 1984

This Modified Order revises the Commission's Final Order issued on July 2, 1984, 104 F.T.C. 1, which requires a Beverly Hills operator of a chain of proprietary hospitals to divest French Hospital, located in San Luis Obispo, California, and provide the Commission, for a period of ten years, with advance notification of its intention to acquire any hospital costing $1 million or more in the 13-state area specified in the order. As revised, the Modified Order retains the advance notification requirement of the original order, but sets forth in detail the manner in which the firm must prepare and submit the notification to the Commission, and the supplemental information that should be included.

ORDER AND OPINION OF THE COMMISSION GRANTING IN PART AND DENYING IN PART COMPLAINT COUNSEL'S PETITION FOR RECONSIDERATION

BY CALVANI, *Commissioner*:

I. Introduction

On July 2, 1984, the Commission issued its Final Order and Opinion in *American Medical International, Inc.* [hereinafter "order"] [104 F.T.C. 1]. The Commission held that respondents' acquisition of French Hospital in San Luis Obispo, California, violated Section 7 of the Clayton Act, as amended, 15 U.S.C. 18 (1976), and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. 45 (1976). The Commission rejected Complaint Counsel's request that respondents be prohibited, for a period of ten years, without prior approval of the Federal Trade Commission, from acquiring general acute care hospitals in areas where they already own or operate such a hospital. In so doing, the Commission stated:

> Instead of requiring AMI to obtain prior approval from the Commission for acquiring other hospitals under the conditions set forth by Judge Barnes, we believe that many of Complaint Counsel's more legitimate objections to such acquisitions can be satisfied by requiring AMI simply to notify the Commission of its intention to make an acquisition of the variety contemplated by Judge Barnes' order. This would enable the Commission to investigate an acquisition that appears to involve significant antitrust problems, and take enforcement action against the acquisition before the acquisition has progressed beyond the "point of no return," while at the same time preserve the

> procompetitive benefits attributable to AMI's presence in the acquisition market. This is not intended to replace Hart-Scott-Rodino filing requirements that may apply to any of [2] AMI's future acquisitions, but is to apply to AMI's hospital acquisitions which, for one reason or another, may be exempt from those filing requirements. We contemplate that notification by AMI of such acquisitions is to be provided when AMI's Board of Directors or Executive Committee authorizes issuance of a letter of intent or enters into a purchase agreement to make such an acquisition, whichever is earlier.

Slip op. at 60 [104 F.T.C. at 226]. Complaint Counsel has petitioned for reconsideration of certain portions of the Commission's Order in *American Medical International, Inc.* pursuant to Rule 3.55 of the Commission's Rules of Practice. Respondent American Medical International, Inc. ("AMI") replied in opposition to the Petition by memorandum dated August 6, 1984. AMI's Opposition to Petition for Reconsideration of Final Order [hereinafter "AMI Memorandum"].

After reviewing these filings, as well as the relevant briefs, decisions, orders, and transcripts in this matter, we have concluded that Complaint Counsel's Petition is an appropriate Rule 3.55 petition as to the arguments and modifications it presents concerning prior notification, but that it is inappropriate as to the arguments and modifications it presents concerning prior approval. We have determined that the Order should be modified so as to accomplish the purposes intended by the Commission's Opinion and Order of July 2, 1984. The Order as revised is designed to set forth the details of the prior notification requirement imposed under the Order so as to permit Commission staff to make a meaningful review of AMI's [3] proposed acquisition while, at the same time, guarding against imposing undue burden on AMI as a participant in the acquisition market for general acute care hospitals.

II. Complaint Counsel's Petition for Reconsideration is Appropriate

AMI challenges Complaint Counsel's Petition for Reconsideration on two grounds. First, AMI contends that the Petition does not satisfy the requirements of Rule 3.55 of the Commission's Rules of Practice because it fails to raise any "new questions . . . upon which petitioner had no opportunity to argue before the Commission."[1] Second, AMI argues that the Petition should be denied because the modifications requested would harm AMI's ability to compete for new acquisitions and would "undermine the balance struck in the Commission's order between regulatory review and competitive vitality." AMI Memorandum at 2.

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[1] Rule 3.55 of the Commission's Rules of Practice, 16 C.F.R. 3.55 provides, in pertinent part: "any petition filed under this subsection must be confined to new questions raised by the decision or final order and upon which the petitioner had no opportunity to argue before the Commission."

In support of its contention that the Petition fails to satisfy the criteria of Rule 3.55, AMI cites to portions of the briefs that it submitted to Administrative Law Judge Barnes and to the Commission in this matter, and to the transcript of the oral argument before the Commission. There, AMI claims that it raised the issue of prior notification and that Complaint Counsel had an opportunity to present its views on this issue. [4]

In briefs submitted by AMI (both to Administrative Law Judge Barnes and to the Commission), the prior approval remedy was the focus on the "fencing-in" discussion. In AMI's trial brief to Judge Barnes, AMI made only passing reference to a prior notification remedy; the overwhelming part of the "fencing-in" discussion addressed the unfairness of a prior approval requirement. Although AMI had cited to a consent decree involving a hospital merger that had employed a prior notification remedy, *United States v. Hospital Affiliates International, Inc.*, 1982-1 Trade Cas. (CCH) ¶64,696 (E.D. La. 1982), AMI included no discussion in its trial brief of the relative benefits, disadvantages, or problems associated with using this remedy or the mechanics of its use. *See* Trial Brief of Respondent American Medical International, Inc. at 99 & 100.

Similarly, the prior approval remedy was the focus of the "fencing-in" discussion in the two briefs submitted to the Commission by AMI. In its brief on appeal, AMI criticized the prior approval remedy as unfair, unwarranted, and anticompetitive. The only reference in AMI's brief to an alternative to a prior approval "fencing-in" appeared in a footnote that contained citations to two Justice Department merger cases in which prior notification remedies were employed. *See United States v. Stroh Brewery Co.*, 1982-83 Trade Cas. (CCH) ¶65,037 (D.D.C. 1982); *United States v. Hospital Affiliates International, Inc.*, 1982-1 Trade Cas. (CCH) ¶64,696 (E.D. La. 1982). Although AMI cited these two consent decrees, it failed to include any discussion of the advantages, [5] disadvantages, or justifications for use of this remedy. Respondent's Brief on Appeal From Initial Decision at 70 n.87. AMI's Reply Brief again stressed the unfairness of a prior approval remedy and suggested that a prior notification remedy would be much more "reasonable" in the circumstances of this case. AMI's Reply Brief contained no discussion of the mechanics of a prior notification requirement.

Although Complaint Counsel made reference to prior notification as a "fencing-in" remedy in its briefs in this matter, it did not do so in any meaningful way. Complaint Counsel referred in a footnote to premerger notification as a "fencing-in" remedy. *See* Complaint Counsel's Answering Brief at 65 n.92. In this reference, Complaint Counsel simply points out that a process involving premerger notification was available to the Commission as an alternative to a prior approval "fencing-in" provision. Complaint Counsel's brief contains no further discussion of this point, or of the prior notification remedy generally. There was no discussion of, or reference to, prior notification "fencing-in" in Complaint Counsel's brief to Administrative Law Judge Barnes.

Thus, it appears that Complaint Counsel in its briefs argued for prior approval "fencing-in." Administrative Law Judge Barnes ordered this remedy in the initial order in this case. *See* Initial Decision at 183–89. AMI argued that "fencing-in" was unnecessary and that, even if the acquisition were found to be violative of Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act, prior approval "fencing-in" was not [6] warranted. Both parties focused their discussions on the justification, or lack thereof, for a prior approval remedy, and it appears that the issue of how to devise a prior notification remedy that could be employed effectively by the Commission to monitor future AMI acquisitions simply was never discussed.

As AMI correctly notes, Chairman Miller, in oral argument, did raise the issue of whether a prior notification remedy would adequately "fence-in" respondents, assuming the finding of an unlawful acquisition. Complaint Counsel responded to Chairman Miller's question by pointing out three deficiencies with a prior notification "fencing-in" requirement: (1) the Commission would not have credible information with which to assess a proposed acquisition; (2) the Commission might not have the time it needed to assess the competitive impact of the proposed acquisition; and (3) the Commission would not have any indication as to how quickly the proposed acquisition could be consummated. *See* Transcript of Oral Argument at 53. However, although Complaint Counsel's arguments at oral argument in this matter are similar to the arguments raised in Complaint Counsel's Petition, it does not appear that Complaint Counsel had a meaningful opportunity to argue them before the Commission at that time. Chairman Miller merely posed the possibility of a prior notification requirement, and Complaint Counsel responded in general terms without proposing any specific suggestions to deal with these potential problems. Complaint Counsel's discussion of the problems associated with a prior notification remedy at oral argument occupies only three-quarters of a page in a sixty-eight page [7] transcript. It is not reasonable to conclude that Complaint Counsel had an opportunity to discuss the practical problems associated with this remedy or the mechanics for putting it into use.

After reviewing AMI's briefs and the oral argument transcript, as well as the briefs submitted by Complaint Counsel in this matter, we conclude that there was no opportunity for Complaint Counsel to address the prior notification issue in a meaningful way earlier in this case. This is due principally to the fact that the *operation* of a prior notification requirement was not at issue earlier in the case, an issue quite different from the *propriety* of imposing a prior approval requirement for future AMI acquisitions. Although Complaint Counsel's Petition for Reconsideration raises some of the issues that were articulated during the oral argument, the Petition discusses, analyzes, and develops these items so that AMI and the Commission can focus for the first time on the difficulties and the practical problems associated with the use of a prior notification remedy. It presents information and specific suggestions that could not have been presented earlier in the case because prior notification "fencing-in" was not at issue until the Commission opted to make it one by rejecting the prior approval provision. When the Commission chose to impose a prior notification requirement on AMI in the order, the practical problems associated with this requirement suddenly became significant for consideration by Complaint Counsel and AMI. Since neither Complaint Counsel nor AMI was in a position to [8] discuss this hypothetical remedy with any degree of precision prior to the Commission's Decision and Order, Complaint Counsel's Petition for Reconsideration is the only means available to Complaint Counsel to present to the Commission suggestions as to how to make the prior notification remedy effective. Thus, we find that those portions of Complaint Counsel's Petition that seek to modify the prior notification provision contained in Section III of the Commission's Final Order present appropriate areas for reconsideration under Rule 3.55 of the Commission's Rules of Practice, which we examine below.

AMI claims that the fact that the petitioning party had an "opportunity to argue" bars a motion for reconsideration under Rule 3.55, citing *Holiday Magic, Inc.*, 85 F.T.C. 19, 20 (1975), *Ash Grove Cement Co.*, 86 F.T.C. 606, 607 (1975), and *National Association of Women's and Children's Apparel Salesmen, Inc.*, 78 F.T.C. 1584, 1585–86 (1970), in support of this proposition. However, we find that these decisions are inapposite to the case at bar. In *Holiday Magic, Inc,,* the Commission apparently had "fully considered in reaching its final decision the arguments raised by counsel in the motion to reconsider." 85 F.T.C. at 20. Here, we gave no such consideration to these matters.[2] In *Ash Grove Cement Co.*, the Commission found that respondent "had [9] an opportunity, which it exercised, to argue before the Commission" the very issues that it addressed in its petition for reconsideration. 86 F.T.C. at 607. Similarly, in *National Association of Women's and Children's Apparel Salesmen, Inc,*, the Commission found that "respondents have had opportunities and have made use of such opportunities" to argue the same points raised in their petition for reconsideration. 78 F.T.C. at 1587, There, the matters were discussed extensively in briefs and oral argument. Here, not only was the opportunity never exercised but, in fact, it never existed since the operation of the prior notification requirement was not put in issue before the Commission issued its Final Order on July 2, 1984. None of the three dozen or so reported decisions examining Rule 3.55 that we have uncovered through independent legal research suggests a contrary conclusion.

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[2] AMI's "opportunity to argue" contention in *Holiday Magic* presumably refers to the portion of respondent's motion for reconsideration relating to substitution of counsel in that case. The facts are totally different in this case, and we cannot seriously entertain AMI's reliance on this facet of that case for the proposition that it asserts in the case at bar.

However, a portion of Complaint Counsel's Petition for Reconsideration reasserts an argument already presented to, and rejected by, the Commission. These modifications would require AMI to obtain Commission approval for a ten year period for any hospital it seeks to acquire in San Luis Obispo County, California. Both parties briefed the prior approval remedy fully before Administrative Law Judge Barnes and the Commission, and it appears that Complaint Counsel's request for reconsideration of this remedy for any geographic market, including San Luis Obispo County, does not present "a new question . . . upon which petitioner had no opportunity to argue before the Commission." Accordingly, we find that the specific modifications presented [10] with regard to Section IV of the Order (and the arguments marshalled in support of these modifications at pages 11 and 12 of Complaint Counsel's Petition) are not appropriate areas for reconsideration under Rule 3.55, and thus this portion of Complaint Counsel's Petition will be denied.

III. The Mechanics of Prior Notification

The Commission's Order requires AMI to notify the Commission when it seeks to acquire a hospital in any of thirteen states, if the acquisition would cost in excess of $1 million and the acquisition would provide AMI with a 20% or more share of the acute care hospital beds in a specifically designated area. Under the Order, AMI is directed to notify the Commission of its intent to acquire a covered hospital either when it issues a letter of intent or enters into a purchase agreement, whichever is earlier,

Complaint Counsel's Petition for Reconsideration focuses on the "fencing-in" provision that the Order imposes. Complaint Counsel requests reconsideration and modification of this provisions and proffers specific language to accomplish the suggested modifications.

Complaint Counsel seeks to modify the prior notification requirement in five specific ways, discussed below.

First, Complaint Counsel requests that the Order provide a specific notification period so that AMI will be required to give the Commission notice of any covered acquisition at least thirty days prior to completion of the acquisition (or fifteen days in [11] the case of a cash tender offer). Petition at 9. Complaint Counsel argues that without a specified notification period in the Order, AMI would be permitted wide discretion in notifying the Commission of covered acquisitions, and that the Commission could be left without sufficient time to obtain the evidence necessary to seek an injunction to block an illegal acquisition. *Id.* at 3. Complaint Counsel contends that a thirty day notification period would provide the Commission with sufficient time with which to assess the acquisition, obtain evidence, and move to enjoin the acquisition if necessary. *See id.* at 3 & 5–6.

Second, Complaint Counsel recommends that the Order require written prior notification of a covered acquisition. *Id.* at 3 & 9. Complaint Counsel suggests that since AMI's notification may trigger significant action by the Commission (such as obtaining evidence sufficient to support an injunction), the notice triggering such efforts by the Commission should be written notice, not oral. *See id.* at 5.

Third, Complaint Counsel requests that language requiring the submission of specific information be provided in the Order so that the Commission will have the opportunity to make an informed decision as to whether the proposed acquisition is lawful. *Id.* at 6. Complaint Counsel points to the difficulties in obtaining information from companies under investigation, particularly if compulsory process and enforcement procedures are required. *Id.* at 4–5. Complaint Counsel, therefore, recommends that the Order provide the Commission with an efficient, orderly, [12] and equitable way of obtaining specific information needed to assess the competitive impact of a covered acquisition. *See id.* at 9–11.

Fourth, Complaint counsel requests that the Order provide Commission staff with a reliable way of obtaining additional information in a timely fashion in the event that the initial information provided is not sufficient to fully assess the impact of the covered acquisition. *Id.* at 8. Complaint Counsel suggests that in some acquisitions, additional time and information may be required to assess the competitive impact. *Id.* at 10. Complaint Counsel argues, therefore, that the Order should provide a way for obtaining more information and additional time in which to assess that information without forcing the Commission to rely on purely voluntary production.

Fifth, Complaint Counsel requests that a prior approval "fencing-in" provision be added to the Commission's Order to cover AMI hospital acquisitions in San Luis Obispo County. *Id.*, at 11–12. However, since we have determined that this issue is not appropriate for a Rule 3.55 Petition, this issue will not be addressed herein.

AMI's memorandum in opposition to Complaint Counsel's Petition argues that a modified prior notification provision similar to the one contained in Complaint Counsel's Petition would harm AMI competitively. AMI Memorandum at 6. AMI contends that the Order, as originally crafted, struck a balance between the Commission's desire to monitor certain acquisitions by AMI that are not subject to Hart-Scott-Rodino reporting requirements [13] and the need to " 'preserve the procompetitive benefits attributable to AMI's presence in the acquisition market.' " *Id.*, citing slip op. at 60 [104 F.T.C. at 226 (1984)]. Under the proposed modification, AMI contends that in every case it would be required to wait for thirty days plus any extensions allowable under Hart-Scott-Rodino, *id.* at 1 & 7 and, since the proposed Order would apply only where Hart-Scott-Rodino was not otherwise applicable, AMI's competitors in the hospital acquisition market would not have to condition their bids on compliance with these regulatory strictures. *See id.* AMI argues that "the proposed order would eliminate AMI's procompetitive presence in circumstances such as the sale of county-owned hospitals to which HSR does not apply," *id.* at 9, and "eliminate AMI's procompetitive presence in covered transactions [and] deprive the public of the benefits that the order was intended to preserve." *Id.* at 12.

AMI does not make a convincing showing that a reasonable notice requirement would harm it competitively or place it at a competitive disadvantage vis-a-vis its competitors in the hospital acquisition market. By arguing that "the proposed modification would uniquely handicap AMI and therefore effectively remove it from the market for acquisitions covered by the order," *id.* at 5, it is apparent that AMI misconstrues the concerns that the Commission expressed when it rejected the prior approval requirement. Under the prior approval requirement ordered by Administrative Law Judge Barnes, AMI would be at a competitive disadvantage due principally to an additional regulatory hurdle that it must jump in order to consummate the [14] acquistion of a hospital. This additional hurdle, which for all intents and purposes (subject to further appellate review) constitutes a veto over AMI acquisitions, would likely make a prospective seller of a hospital reluctant to deal with AMI. In practical terms, this would reduce AMI's leverage in negotiating an acquisition and might necessitate AMI paying a premium in price for a potential acquisition over what "unfettered" acquirers, AMI's competitors, would be willing to pay. In the highly competitive market for hospital acquisitions, this would likely eliminate AMI as a viable competitor.

However, the situation with regard to prior notification is quite different from that of prior approval. AMI does not set forth any evidence demonstrating that a notification provision requiring submission of detailed market information would in any way burden an acquisition program. Such an advance notification requirement would not impose any undue burden on AMI because it does not inject any uncertainty into the acquisition process; instead, all it does is afford the Commission a meaningful opportunity to review the competitive impact of the acquisition.

AMI's arguments confuse prior approval and prior notification. Prior approval would preclude AMI from making a definitive purchase commitment; prior notification does not, as even AMI admits. AMI suggests that Complaint Counsel's proposed modifications would make an AMI bid "a conditional offer," *id.* at 7, a "conditioned transaction[ ]," *id.* at 8. But, at the same time, AMI admits that prior notification requirements, such as [15] those imposed under Hart-Scott-Rodino, do not make such a transaction "conditional." According to AMI witness Weisman:

> [Sellers of hospitals] do not want conditional transactions. They don't view Hart-Scott-Rodino generally as a condition anymore than they view, for example, a preparation of a definitive agreement as a condition.

Id., quoting Hearing Transcript page at 1727 (Weisman) [hereinafter "Tr."]. Similarly, AMI witness Reilly stated:

> Each of these transactions are, from the seller's perspective, time critical. And as it would be for you as an owner of a substantial piece of real estate, *once you have decided to sell it, you want to get it committed and know it is locked in.* It may take some time for escrow to close, but you want to know you have a deal.

Id., quoting Tr. 1848 (Reilly) (emphasis added). AMI's arguments that prior notification will make its acquisition bid conditional are disingenuous. Under prior notification, the Commission cannot stop a proposed acquisition except by successfully bringing suit, either in federal court or through an administrative complaint. Thus, the notification requirement does not in any way impose a prior approval constraint over the acquisition, as AMI seems to imply. Except for the compliance costs (principally, administrative and legal costs associated with preparation of the notification itself), such a requirement does not diminish AMI's leverage in negotiating an acquisition nor would it necessitate AMI paying a premium price for the acquisition in order to out-bid competitors in the acquisition market. If anything, it injects increased certainty into the acquisition because it subjects the acquisition to an early (albeit, non-binding) antitrust review and, as a practical [16] matter, lessens the likelihood that the Commission might seek divestiture of the acquisition at some later date on antitrust grounds.

On the other hand, in adopting the advance notification provision contained in the original Order, we never intended to deny staff the time and resources needed "to investigate an acquisition that appears to involve significant antitrust problems, and take enforcement action against the acquisition before the acquisition has progressed beyond the 'point of no return.'" *See* Petition at 2, quoting slip op, at 60 [104 F.T.C. at 226 (1984)]. A simple statement by respondents of their intent to enter into an acquisition, without more, does not provide Commission staff with a meaningful opportunity to evaluate the competitive effects of the acquisition. Imposing a reasonable prior notification procedure does not simply "make the [Commission] staff's job *easier,"* as AMI contends, Petition at 6 (emphasis added)—rather, it makes it possible for staff to do the job that we anticipated would be done under the Order—assess the competitive effects of the acquisition. Because of the demands of time, it would be highly unlikely that, through normal channels of investigation, staff would be able to learn of the acquisition, assess its competitive impact, and prepare the legal papers needed to pursue a preliminary injunction in the event that the acquisition posed competitive concerns. AMI's offer in its memorandum to "be responsive to reasonable requests for information," AMI Memorandum at 11, does not by any means constitute a legally enforceable obligation that guarantees an [17] opportunity for meaningful review of a covered acquisition.

However, we are not convinced that there is a need to impose a waiting period on AMI in its covered acquisitions. Although AMI may have wide discretion in the *timing of its making a purchase commitment* to a prospective seller, AMI does not have discretion over the *timing of notification of the commitment* to the Commission. The final order requires AMI to notify the Commission once AMI becomes legally bound to make the purchase, which may be as early as issuance of a letter of intent and is certainly no later than entering into the purchase agreement itself. Market incentives encourage AMI to make this commitment as soon as possible so as to take the assets off the market. Consummation of the acquisition, especially consolidation of the acquired entity's operations with those of AMI, often will be delayed well past the purchase date because of externalities beyond AMI's control, such as state certificate-of-need requirements. As a practical matter, the Commission staff will have enough time, even more than the statutory waiting periods prescribed under Hart-Scott-Rodino, to review the notification filing by AMI and assess the likely competitive effects of the acquisition. Imposing an inflexible waiting period on AMI would subject covered acquisitions to a time constraint that would accomplish little other than disabling AMI vis-a-vis its competitors. We conclude that the Commission staff will have adequate resources, under the present framework, to assess the competitive impact of covered acquisitions and prevent consummation of anticompetitive acquisitions, and that imposition [18] of a waiting period is not necessary.

Complaint Counsel is correct in asserting that "[t]he Commission's expressed intent is similar to the purposes of HSR to provide the government with a meaningful opportunity to challenge unlawful transactions *before* consummation, thus avoiding the problem of constructing post-acquisition relief and preventing injury to the public that would otherwise occur before divestiture." Petition 2 (emphasis in original). A detailed prior notification and reporting requirement would satisfy this concern. Such a requirement is well within the wide discretion accorded the Commission to remedy unlawful practices. *See Jacob Siegel Co. v. FTC*, 327 U.S. 608, 611 (1946). Since the Commission has found prior approval to be appropriate in certain instances, it is fair to conclude that a detailed prior notification requirement (a less drastic remedy than prior approval "fencing-in") is a legally valid remedy that the Commission could order in this case.

Accordingly, we will modify the Final Order in this matter by requiring written notification of AMI's intent to make a covered acquisition.[3] This notification is to be provided when AMI's Board of Directors or Executive Committee, or any entity [19] that is authorized to act on AMI's behalf in such acquisitions,[4] authorizes issuance of a letter of intent or enters into a purchase agreement to make such an acquisition, whichever is earlier. The Modified Order provides for filing information comparable to Hart-Scott-Rodino reporting requirements by AMI in order to permit staff a meaningful opportunity to assess the competitive effects of the proposed acquisition.[5] We will also require that the notification be supplemented with additional information, either in AMI's possession or reasonably available to

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[3] As we did in the Final Opinion and Order, we again caution respondents that this Modified Order does not replace Hart-Scott-Rodino filing and waiting period requirements that may apply to any of AMI's future acquisitions. Where both Hart-Scott-Rodino and this Order apply to a particular acquisition, the Hart-Scott-Rodino reporting and waiting period requirements would supercede operation of this Order. However, where AMI's acquisition is otherwise exempt from Hart-Scott-Rodino, the terms of this Order will govern AMI's filing obligations.

[4] We do this *sua sponte* so as to prevent technical inapplicability of the Order if AMI were to assign acquisition responsiblities to a different AMI committee or entity.

[5] Complaint Counsel has also requested a mechanism for obtaining more information and additional time in which to assess that information without forcing the Commission to rely upon purely voluntary compliance. We deny Complaint Counsel's request for additional time for the same reasons that we have denied the request for a waiting period for the acquisition. However, we can envision some circumstances under which additional information may be necessary to fully assess the competitive effects of an acquisition. Therefore, we will require AMI to comply with reasonable requests by staff for additional information within fifteen days of service of such requests.

AMI, relating to the hospital to be acquired, the AMI hospital in the area, and identification and assessment of the area hospital market.[6] We require this supplemental information because, absent such, it would be difficult to determine the [20] existence and extent of market overlaps resulting from the acquisition.

It is hereby ordered, That, for the foregoing reasons, Complaint Counsel's Petition for Reconsideration is granted in part and denied in part. An appropriate order is appended.

MODIFIED ORDER

I

Complaint Counsel has filed a Petition for Reconsideration of the Commission's Order in this matter issued on July 2, 1984 [104 F.T.C. 1]. Respondents have replied in opposition thereto. The Commission has determined upon review of the matter that its Order of July 2, 1984 should be modified, for the reasons set forth in the accompanying opinion. Therefore,

It is ordered, That for purposes of this Order the following definitions shall apply:

A. *Acquire any hospital* means to directly or indirectly acquire all or any part of the stock or assets of any hospital, or enter into any arrangement by which AMI obtains ownership, management, or control of any hospital, including the right to lease or manage any hospital. [2]

B. *AMI* means American Medical International, Inc., a corporation organized under the laws of Delaware with its principal executive offices at 414 North Camden Drive, Beverly Hills, California, and its directors, officers, agents, and employees, and its subsidiaries, divisions, affiliates, successors, and assigns.

C. *AMISUB (French Hospital)* means the wholly-owned subsidiary corporation of AMI that was established for the purpose of acquiring and operating French Hospital located in San Luis Obispo, California.

D. *County* also means a county equivalent such as a parish in Louisiana.

E. *General acute care hospital,* herein referred to as *hospital(s),* means a health facility, other than a federally-owned facility, having a duly organized governing body with overall administrative and professional responsibility and an organized professional staff that provides 24-hour inpatient care, and whose primary function is to provide inpatient services for medical diagnosis, treatment, and care of physically injured or sick persons with short-term or episodic health problems or infirmities.

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[6] This information should include, where available, patient flow data, annual management and strategic plans, hospital untilization and revenue data, and documents relating to market share, formulation of hospital prices, competitive interaction among area hospitals, planned efficiencies, relations with third-party payers, and physician admitting patterns.

F. *Operate a hospital* also means to own, manage or lease a general acute care hospital.

G. *MSA* and *PMSA* mean, respectively, a Metropolitan Statistical Area and a Primary Metropolitan Statistical Area, as defined as of July 1, 1983 by the Office of Management and Budget, Office of Information and Regulatory Affairs.

II

It is ordered, That within twelve (12) months from the date this Order becomes final, AMI shall divest, absolutely and in good faith, all stock, assets, properties, licenses, leases, and other rights and privileges, tangible and intangible, that AMI acquired from Central Coast Hospital Company, French Hospital Corporation and French Medical Clinic, Inc., together with any [3] subsequent improvements. The purpose of the divestiture is to reestablish French Hospital as a viable competitor in San Luis Obispo County. The divestiture shall be subject to the prior approval of the Federal Trade Commission.

Pending divestiture, AMI shall take all measures necessary to maintain French Hospital in its present condition and to prevent any deterioration, except for normal wear and tear, of any of the assets to be divested so as not to impair French Hospital's present operating abilities or market value.

III

It is further ordered, That for a period of ten (10) years from the date this Order becomes final, AMI shall not, without providing advance notification to the Federal Trade Commission, directly, or indirectly acquire any hospital located in the states of Oregon, California, Texas, Oklahoma, Missouri, Arkansas, Louisiana, Mississippi, Alabama, Georgia, Florida, South Carolina, or North Carolina, if:

A. The hospital to be acquired is within an MSA or a PSMA in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a twenty (20) percent or more share of the licensed general acute care hospital beds within that MSA or PMSA; or

B. The hospital to be acquired is not within an MSA or a PMSA but is within a county in which AMI already operates a hospital and in which AMI, immediately after the acquisition, would operate hospitals that combined have a twenty (20) percent or more share of the licensed hospital beds within that county; or

C. The hospital to be acquired is (1) not within an MSA or a PMSA or a county in which AMI [4] already operates a hospital, but is within thirty (30) miles of a hospital which AMI already operates in another MSA or PMSA or county, and (2) the hospital to be acquired and any hospital(s) that AMI operates combined have a twenty (20) percent or more share of the licensed hospital beds in the area within thirty (30) miles of the midpoint between the hospital to be acquired and any hospital operated by AMI.

Provided, however, That no acquisition shall be subject to this Section III: (1) if the consideration to be paid for the purchase of the hospital, including assumption by AMI of liabilities of its present owners, does not exceed one million dollars ($1,000,000); or (2) if notification of the acquisition is required to be made, and in fact is made, pursuant to Section 7A of the Clayton Act, 15 U.S.C. 18a. Such advance notification shall be provided when AMI's Board of Directors or Executive Committee, or any entity that is authorized to act on AMI's behalf in such acquisitions, authorizes issuance of a letter of intent or enters into a purchase agreement to make such an acquisition, whichever is earlier.

IV

The notification required by Section III shall be the Notification and Report Form set forth in the Appendix to Part 803 of Title 16 of the Code of Federal Regulations, as amended, and shall be prepared and transmitted in accordance with the requirements of that part. The notification required by Section III of this Order shall apply to AMI and shall not apply to any party that AMI seeks to acquire. However, AMI shall provide at the same time of the filing of the Notifiction and Report Form supplemental information, either in AMI's possession or reasonably available to AMI, relating to the hospital to be [5] acquired, the AMI hospital in that geographic area, and identification and assessment of the area hospital market. Such supplemental information should include, where available, patient flow data, annual management and strategic plans, hospital utilization and revenue data, and documents relating to market share, formulation of hospital prices, competitive interaction among area hospitals, implementation of certificate of need standards in the area, planned efficiencies, relations with third-party payers, and physician admitting patterns.

AMI shall comply with reasonable requests by the Commission staff for additional information within fifteen (15) days of service of such requests.

Any acquisition subject to Section III pf this Order, involving an arrangement to lease, manage, or control a hospital, shall be fully described in the notification regardless of whether the acquisition involves the acquisition of any stock or assets of a hospital.

V

It is further ordered, That AMI shall, within sixty (60) days after the date this Order becomes final and every sixty (60) days thereafter until it has fully complied with the provisions of Section II of this Order, submit a report in writing to the Federal Trade Commission setting forth in detail the manner and form in which it intends to comply, is complying, and has complied with these provisions.

Such compliance reports shall include a summary of all contacts and negotiations with potential purchasers of the stock [6] and assets to be divested under this Order, the identity and address of all such potential purchasers, and copies of all written communications to and from such potential purchasers.

AMI also shall submit such further written reports as the staff of the Federal Trade Commission may from time to time request in writing to assure compliance with this Order.

VI

It is further ordered, That AMI shall notify the Federal Trade Commission at least thirty (30) days prior to any proposed corporate change, such as dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries, or any other change in the corporation that may affect compliance with the obligations arising out of this Order.

Commissioner Bailey voted in the negative.

IN THE MATTER OF

BATUS INC.

MODIFYING ORDER, ETC., IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 7 OF THE CLAYTON ACT

Docket C-3099. Consent Order, Dec. 6, 1982—Modifying Order, Nov. 13, 1984

This Order reopens the proceeding and modifies the divestiture order issued against a department store operator, 100 F.T.C. 553 (1982), which required the company to divest department stores sufficient to reduce its floor space by 200,000 square feet and its sales volume by $20 million, as measured by 1981 sales. To date, the operator has received Commission approval for divestitures totalling 492,000 square feet and $17.9 million in 1981 sales, and has petitioned for modification of the Order stating that any further divestiture would "account for substantially more than $20 million in 1981 sales." Following an examination of the record and the company's plan of divestiture, the Commission concluded that the company had made a good faith compliance effort and that divestiture of a much larger store to satisfy the remaining $2.1 million sales volume requirement was not in the public interest. Therefore, Paragraph II of the original Order has been modified by substituting for the phrase in the first sentence reading "in an amount not less than $20 million as measured by fiscal 1981 sales" the phrase "in an amount not less than $17.9 million as measured by fiscal 1981 sales."

ORDER REOPENING PROCEEDING AND MODIFYING ORDER

By petition filed July 17, 1984, respondent BATUS Incorporated ("Batus") requests, pursuant, to Section 5(b) of the Federal Trade Commission Act (15 U.S.C. 45(b)), that Paragraph II of the Commission's Order issued in this matter on December 6, 1982 [100 F.T.C. 553], be modified so that Batus will not be required to make further divestitures to reach the $20 million sales volume stan dard set out in Paragraph II of the Order. Pursuant to Section 2.51 of the Commission's Rules of Practice and Procedure, the petition was placed on the public record for thirty days. No comments were received.

The order required Batus to divest department stores in the Milwaukee, Wisconsin SMSA sufficient to reduce its floor space by 200,000 square feet and its sales volume by $20 million, as measured by 1981 sales. To date Batus has received Commission approval for divestitures totalling 492,000 square feet and $17.9 million in 1981 sales.

The Commission has reviewed Batus' plan of compliance with the divestiture requirements of the Order, including its selection of stores, and the efforts undertaken to fulfill its obligations and believes Batus has made a good faith effort to accomplish full compliance with the Order. The record also demonstrates that sale of an additional store having a 1981 sales volume in the range of $2.1 million to a viable competitor is unlikely. Given Batus' good faith compliance effort and the degree of divestiture already obtained, we believe that it is not in the public interest to require a divestiture of a much larger store to satisfy the remaining $2.1 million sales volume requirement. Therefore, we find that modification of certain language in Paragraph II of the order is in the public interest.

Accordingly, *it is ordered*, that the proceeding be, and it hereby is, reopened for the purpose of modifying the Order entered therein;

It is further ordered, That Paragraph II is amended by substituting in lieu of the phrase at the end of the first sentence which reads:

in an amount not less than $20 million as measured by fiscal 1981 sales.

the phrase,

"in an amount not less than $17.9 million as measured by fiscal 1981 sales."

IN THE MATTER OF

TEAC CORPORATION OF AMERICA

MODIFYING ORDER IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT

Docket C-2752. Consent Order, Oct. 24, 1975—Modifying Order, Nov. 16, 1984

This Order grants the request of a Montebello, California supplier of high fidelity audio components to reopen the proceedings and delete Paragraph I(11) from the Commission's October 24, 1975 Consent Order, 86 F.T.C. 981, *modified,* November 25, 1983, 102 F.T.C. 1814, so as to permit the firm to prevent transshipment of its products to dealers who did not meet non-discriminatory standards of promotion, service and display. After considering company's arguments and other relevant information, the Commission concluded that the public interest warranted reopening and modifying the Order as requested. The transshipment provision had served its remedial purpose. There was no indication that the firm had engaged in resale price maintenance or breached the transshipment provision. Nor was there anything in the record to suggest a need to retain the provision as a fencing-in mechanism, or as a means of preventing anticompetitive effects from nonprice vertical restraints. Accordingly, the Commission ordered that the matter be reopened and Paragraph I(11) of the Order deleted.

ORDER REOPENING AND MODIFYING ORDER ISSUED ON OCTOBER 24, 1975

On June 6, 1984, respondent TEAC Corporation of America ("TEAC") filed its "Request to Reopen Proceedings and to Modify Consent Order" ("Request"), pursuant to Section 5(b) of the Federal Trade Commission Act, 15 U.S.C. 45(b), and Section 2.5 of the Commission's Rules of Practice. The Request asked the Commission to reopen the proceeding in Docket No. C-2752 and modify the order issued by the Commission in this case on October 24, 1975—as modified by an order issued November 25, 1983—to remove a provision that restricts TEAC's ability to limit transshipment of its products. TEAC's Request was placed on the public record for thirty days and no comments were received.

After reviewing TEAC's request and other available information, the Commission has concluded that the public interest warrants reopening and modifying the order in the manner requested by TEAC. The transshipment provision of the order [2] (Paragraph I(11)) was adopted principally as a "fencing in" restraint ancillary to the order's ban on resale price maintenance ("RPM"). TEAC has shown that it does not fix the prices at which its authorized dealers resell TEAC products, that TEAC product prices vary from dealer to dealer, and that the transshipment provision therefore has encouraged the emergence of intrabrand price competition in TEAC products. Consequently, Paragraph I(11) need not be retained for that purpose.

To the extent that Paragraph I(11) was also intended to remedy alleged anticompetitive effects of vertical practices other than RPM, the Supreme Court decision in *Continental T. V., Inc.* v. *GTE Sylvania, Inc.*, 433 U.S. 36 (1977)—issued after the original order in this matter—makes further analysis necessary. As the Court explained, non-price vertical restraints may either enhance or impede economic efficiency and consumer welfare, depending upon whether the fundamental purpose or effect of the restraints is on balance to enhance or exploit market power or instead to promote a more efficient form of distribution. It follows that devices that facilitate the imposition of non-price vertical restraints—such as transshipment restrictions—similarly may be beneficial in some situations and harmful in others. These practices are not inherently suspect or so plainly anticompetitive that they can be condemned without more extensive analysis under the rule of reason. The Commission has relied upon *Sylvania* to conclude that [3] it will only prohibit non-price vertical restraints that have "a probable adverse effect on *inter*brand competition" at either the manufacturer or the dealer level.[1]

The foregoing cases establish the need to evaluate the likely consequences of non-price vertical restraints in the recording equipment industry under the rule of reason in considering TEAC's petition. Vertically imposed transshipment restrictions such as those at issue here are most likely to be used in conjunction with a program of other non-price vertical restraints that effectively limits the entities with whom the manufacturer will deal. TEAC apparently seeks authority to use transshipment restrictions to facilitate a distribution program involving only carefully selected dealers. If TEAC's petition is granted, TEAC could use transshipment restrictions to facilitate the imposition and enforcement of other non-price vertical restraints.

I.

When market power either does not exist or cannot be sustained, anticipated efficiency gains are the only rational basis for a manufacturer to impose a vertical restraint. Only procompetitive practices will survive the market test when the [4] creation or enhancement of market power is unlikely; the market does not reward inefficient distribution practices. Thus, when the exercise of market power in a properly defined relevant market is unlikely,[2] we consider non-price vertical restraints to be efficiency enhancing in purpose and effect, and therefore lawful, without further inquiry.

---

[1] *Beltone Electronics Corp.*, 100 F.T.C. 68, 208 (1982). The Commission identified two different adverse effects upon interbrand competition that could satisfy this standard. First, the Commission indicated that non-price vertical restraints might in some circumstances support or increase the likelihood of collusion among competing firms. *Id.* at 206–07. Second, the Commission indicated that non-price vertical restraints might in some circumstances create or enhance the market power of one or more competing firms. *Id.* at 207.

Market power can be exercised either by a dominant firm or through the action of competitors acting in concert. Because no firm can claim dominance in the recording equipment market (*see* pp. 6–8, *infra*), we will focus our attention on the possibility of collusive activities in this market.[3] In this context, our concerns are: (1) whether the firms that use the questioned non-price vertical restraints constitute a significant competitive threat; and (2) whether such a threat is effectively constrained by the remainder of the market.

In general, the likelihood of collusion depends on the expected gains from and costs of forming and enforcing a collusive scheme. Collusion is attractive only to the extent [5] that there are potential gains from cooperation, such as when market demand is inelastic at the competitive price. As the elasticity of market demand at the competitive level increases, the potential gains from collusion decline. Collusion becomes less likely as the costs of forming or enforcing a collusive agreement increase. The likelihood of collusion is directly related to, among other things, the overall level of market concentration, the distribution and aggregate value of the market shares of the firms using the challenged practice, and the presence and significance of barriers to entry. The likelihood of collusion is inversely related to, among other things, the number of fringe firms and the diffusion of their market shares.[4]

The factors that affect the feasibility of successful collusion often can be used to conclude that it is probably not a threat to consumer welfare in a given market. For example, collusion is unlikely to be successful in an unconcentrated [6] market.[5] Moreover, even in a somewhat concentrated market, if the firms actually using the vertical restraint at issue do not collectively possess and are not likely to secure market power, then the restraint is unlikely to facilitate the creation or maintenance of market power. In particular, non-price vertical restraints implemented by new entrants or small established firms are unlikely to threaten consumer welfare. The absence of barriers to entry is also likely to prevent successful collusion. On the facts in this case, we need go no further than to determine that successful collusion in the recording equipment market is highly unlikely. We do not confront a market in which non-price vertical restraints may create both market power and consumer benefits, and we therefore do not need to balance positive and negative effects upon competition and consumer welfare.

---

[2] The Commission adheres to the principles of relevant market definition it adopted in 1962. *Statement of Federal Trade Commission Concerning Horizontal Mergers ("FTC Merger Statement")*, Trade Reg. Rep. (CCH) No. 546 (June 16, 1962), at 71, 84–85.

[3] The imposition of vertical restraints as a result of collusive activities in the recording equipment market might arise in one of two forms. First, distributors or retailers might act in concert to coerce manufacturers to impose vertical restraints on their competitors in order to limit competition in distribution or retailing. Second, manufacturers might impose vertical restraints in concert in order to facilitate the monitoring of a collusive agreement or otherwise to enhance the exercise of collusive market power.

[4] *E.g.*, R. Posner, *Antitrust Law: An Economic Perspective* 56–59 (1976). The Commission has recognized that other factors, in addition to those enumerated, also affect the likelihood of successful collusion. *FTC Merger Statement*, *supra* note 2, at 71, 75–80.

[5] In the context of horizontal mergers, the Justice Department has broadly characterized markets with Herfindahl-Hirschman Indexes ("HHIs") below 1000 as "unconcentrated," and markets with HHIs equal to or above 1000 as "moderately concentrated." *Justice Department Merger Guidelines*, 49 FR 26823, 26830–31 (1984). An HHI of 1000 or less certainly indicates an unconcentrated market; however, for the purpose of analyzing non-price vertical restraints, it may also be appropriate to characterize markets with somewhat higher HHIs as unconcentrated.

II.

We commence our analysis of the TEAC request by evaluating the threat of the exercise of market power. TEAC competes in the home and professional recording equipment segments of the high fidelity audio components market. The facts pertaining to the recording equipment industry indicate that no firm has a dominant [7] position and that the chance of successful collusion is remote. TEAC's share of the home recording market fell substantially between 1974 and 1983, so that it is now only the sixth largest firm in the industry. Moreover, only one firm has more than eight percent of the home recording market. The structure of the distribution and retailing segments of the home recording equipment market is even more diffuse. Thus, existing levels of concentration in this market at the manufacturer, distributor, and retailer levels are significantly lower than the threshold level that should trigger concern with the possibility of successful collusion.

In addition, since the original order was entered, at least twenty manufacturers have entered and/or increased their participation in the high fidelity audio components market and its tape recording equipment segment, indicating the absence of significant impediments to entry. There is similarly no evidence of barriers to entry into the distribution or retailing of home recording equipment. For example, the typical TEAC dealer carries as many as seven competing lines of tape recording equipment. The professional recording segment is similarly competitive. There are at least twelve manufacturers of professional recording equipment. Moreover, professional equipment is sold to knowledgeable buyers on a bid basis by geographically dispersed dealers, making successful collusion among manufacturers even more difficult and unlikely. [8]

In summary, the low levels of concentration and the absence of barriers to entry into the manufacture, distribution, and retailing of recording equipment make the creation of market power in this industry an extremely remote possibility.

CONCLUSION

The transshipment provision in question has served its remedial purpose. There is no indication that TEAC has engaged in RPM (or has breached the transshipment provision) from October 24, 1975 to date, and nothing in the record suggests that there is a need to retain the transshipment provision as a fencing-in mechanism to ensure that TEAC does not reinstitute RPM.

The transshipment provision does not appear to be needed to prevent anticompetitive effects from non-price vertical restraints either. Because the recording equipment market and its constituent segments are unconcentrated at the manufacturer, distributor and retailer levels, and because there has been substantial entry, we conclude that neither market dominance nor successful collusion is likely. The record presented by TEAC and other information indicate that transshipment restraints imposed by TEAC would pose no threat to interbrand competition. At the same time, Paragraph I(11) imposes unnecessary costs by requiring TEAC to prospectively specify and apply qualification standards for all dealers who seek to secure TEAC products transshipped by TEAC's authorized dealers, including dealers not served directly by TEAC. We therefore conclude that an effort by TEAC to control transshipment is very unlikely to harm competition. [9]

Accordingly, *it is ordered* that this matter be, and it hereby is, reopened and that Paragraph I(11) of the order be, and it hereby is, deleted.

Commissioner Bailey voted in the negative.

IN THE MATTER OF

GROLIER, INCORPORATED, ET AL.

MODIFYING ORDER IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT

Docket 8879. Final Order, March 9, 1982—Modifying Order, Nov. 19, 1984

This Order reopens the proceeding and modifies the 1978 Commission Order, 91 F.T.C. 315, revised December 10, 1981 and made final March 9, 1982, 99 F.T.C. 379, which required a seller of encyclopedias to cease engaging in certain unfair and deceptive trade practices in connection with the sale of its products and the recruitment of door-to-door sales personnel. Pursuant to the company's petition, the Order has been modified to closely conform with the modification granted in *Encyclopaedia Britannica, Inc., et al.*, 100 F.T.C. 500. Among other things, the Order no longer requires the firm to include in employment ads information such as the nature of the employment, the location of the company or the basis of compensation, so long as they provide such information to potential employees during the initial job interview. The company may provide information concerning income and expenses to prospective employees when an actual job offer is made. The Order no longer requires the company to disclose in advertisements and promotional material that a sales representative will contact consumers who return inquiry cards, provided the firm can demonstrate through surveys that most readers of the ads understand this implicitly. The business cards of company's sales representatives may be reduced from three-by-five to two-by three-and-a-half inches, and the respondent may follow relevant Commission guidelines when making "free" offers, and is no longer required to attach lists of prices and free products to encyclopedia contracts.

ORDER REOPENING THE PROCEEDING AND MODIFYING CEASE AND DESIST ORDER

On October 13, 1983, respondents, Grolier, Incorporated, et al., filed a "Request to Reopen Proceedings To Modify Order and Application for Stay of the Order." ("Request") The Order became effective on October 11, 1983. On August 23, and October 4, 1984, Grolier supplemented the "Request" with a revised Appendix B, which sets out the methodology to be used by Grolier to show compliance with Paragraph II.A. of the proposed Order.

Grolier granted the Commission until November 19, 1984 to decide it's "Request". The Commission previously granted Grolier's "Request for Extension of Time" for the Commission to act to allow Grolier more time to complete its surveys bearing on the disclosures required by Paragraphs II.A. and B., which are subject paragraphs of the pending "Request".

Grolier seeks Order modifications virtually identical to those the Commission made to a similar Commission Order against *Encyclo-*

paedia Britannica (Docket No. 8908) [100 F.T.C. 500] on October 5, 1982.

On November 23, 1983 the Commission granted the stay as to Order Paragraphs I C. (2)(3) and (4); I D.; I E.; II A.-E.; II G. (7); II M. (1) and (2); II S.; and Paragraph V, pending resolution of the request for Order modification.

On the basis of the information provided by Grolier and in view of the Order modifications granted to Encyclopaedia Britannica the Commission has determined that pursuant to Section 2.51 of the Commission's Rules of Practice changed conditions of fact and the public interest require that the proceedings be reopened and the Order modified. *It is therefore ordered,* That the proceedings be reopened and the Order modified as follows:

I.

* * * * * * *

B. Misrepresenting, in any manner, the amount of income to be earned by any person or that may be earned by any person, the expenses that may be incurred by any person, the method of payment, or any condition or limitation imposed upon the compensation of any person.

C. Failing to disclose, clearly and conspicuously, in all advertising offering employment in any way involving door-to-door sales that the respondent concerned is recruiting persons for the sole purpose of soliciting or selling.

* * * * * * *

(2) [DELETED]
(3) [DELETED]
(4) [DELETED]

D. Failing to provide clearly and conspicuously, both orally and in writing, to any prospective sales employee at the initial face-to-face interview, and prior to executing any employment agreement with any such person, the following information:

(1) (a) that respondent is recruiting persons for the sole purpose of soliciting or selling;

(b) that the products or services being sold are encyclopedias or services to be used in connection therewith, or in the event that encyclopedias or such related services are not being sold, the products and services being sold; and

(c) the basis for compensating persons so engaged;

(2) that conditions or limitations upon the receipt of compensation, if any, do in fact exist, together with an example of such a material condition or limitation, and that all such conditions and limitations will be stated in detail in an interview in the event an offer of employment is made to such person;

* * * * * * *

(4) that expenses will be incurred by such person in performing required duties, together with an example of such a material expense, and that all such expense items will be stated in detail in an interview in the event an offer of employment is made to such person; and

(5) that such soliciting or selling will be on an "in-home" basis, if such is the fact, or will include soliciting or selling on an "in-home" basis, if such is the fact.

E. Failing clearly and conspicuously to provide, both orally and in writing, to any prospective sales employee at an interview at which an offer of employment is made and prior to executing any employment agreement with any such person, the following information:

(1) A complete and detailed description of each condition and limitation imposed upon the receipt of any compensation;

(2) a complete and detailed description of any expense or expenses any such person may incur in performing the required duties;

(3) (a) the total number of sales employees employed by the office offering the position during the most recent calendar quarter, and (b) the number of sales employees employed by the office who, during the prior calendar quarter, received net earnings equivalent to or greater than the amount represented in the advertisement to which the prospective employee is responding; *provided, however,* that if the office has been in existence for less than three months or has fewer than five sales employees, respondents shall provide the information described above pertaining to the Division in which the office is located; *provided further,* that such information need not be furnished if the prospective sales employee contacts respondents more than ten days following the dissemination of the most recent advertisement that contains representations of earnings. Respondents shall afford any prospective sales employee an adequate opportunity to review and consider the above information prior to requesting execution of any employment agreement.

F. Failing to furnish to persons at an interview when an offer of employment is made and prior to executing any employment agreement with any such person, a copy of Paragraphs I, II and V of this

Order together with a cover letter as set forth in Appendix A attached hereto. Respondents shall afford any prospective sales employee an adequate opportunity to review and consider these provisions of the Order prior to requesting execution of any employment agreement.

G. Making, distributing or using any training tapes, sales manuals, or any other document, method or device which contains any representation or instruction inconsistent with any provision of Paragraph I or Paragraph II of the Order.

II.

* * * * * * *

A. Representing, directly or by implication, in any advertisement or promotional material that solicits participation in any contest, drawing, or sweepstakes, or solicits any response to any offer of merchandise, service, or information, and that employs any return card, coupon, or other device to respond to such solicitation, that a person who replies as requested will not be contacted directly by a salesperson for the purpose of selling respondents' products, unless such is the fact. Such advertisements or promotional material shall comply with this Paragraph only if they meet the criteria set forth in Appendix B.

B. Failing, upon the written request of the Associate Director for Enforcement or his designee, to (1) submit any advertisement or promotional material or (2) test any such advertisement or promotional material, using the procedure set forth in Appendix B, to determine whether it complies with Paragraph II.A.

C. Failing to disclose clearly and conspicuously, during any telephone contact and before commencing any sales presentation to prospective customers, the fact that the individual making the call is either soliciting the sale, rental or lease of publications, merchandise or services for respondents, or is arranging for a sales solicitation to be made, and that if the prospective customer so agrees, the respondent concerned will send a salesperson to visit said prospect for the purpose of soliciting the sale, rental or lease of said publications, merchandise or services.

D. Visiting the home or place of business of any person for the purpose of soliciting the sale, rental or lease of any publications, merchandise or service, unless at the time admission is sought into the home or place of business of such person, a business card of at least 2 inches by 3 1/2 inches containing only the following information, is presented to such person:

(1) the name of the corporation;
(2) the name of the salesperson;
(3) the term "sales representative;"
(4) an address and telephone number at which the corporation or salesperson may be contacted;
(5) the product of the corporation logo or identifying mark.

* * * * * * *

G. Representing, directly or by implication, either orally or in writing that:

(1) Any person telephoning or visiting the home of any prospective purchaser is:

* * * * * * *

(c) telephoning or visiting the home of said prospect for the primary purpose of delivering or disseminating any vacation gift certificate, prizes, gifts, gift certificates, chances in any contest, or any other merchandise or item of chance;

* * * * * * *

(7) any publication, merchandise or service is being offered free, without cost, or is given as a bonus or otherwise to any purchaser of any of respondents' publications, merchandise or services, pursuant to any agreement to purchase, rent or lease any other publication, merchandise, or service, or combination thereof, from such respondent, unless respondent complies with all of the terms of the Federal Trade Commission's "Guide Concerning Use of the Word 'Free' and Similar Representations," 16 C.F.R. 251, which is hereby incorporated into this Order, and with any modifications or changes that are made to this Guide. All of the provisions of the aforesaid Guide shall be construed as mandatory and binding upon the respondents.

* * * * * * *

M. Representing to any person, directly or by implication, either orally or in writing that:

(1) any price is the retail, regular, usual or words of similar import or effect, price for any publication in any binding, merchandise or service, unless such price is an actual, bona fide price for which each such publication has been openly and actively offered for sale in the

recent and regular course of business for a reasonably substantial period of time;

(2) any price is the retail, regular, usual, or words of similar import or effect, price for any set of publications in any binding and in combination with any other publication, merchandise or service, unless such price is an actual, bona fide price for which each such publication has been openly and actively offered for sale in the recent and regular course of business for a reasonably substantial period of time.

* * * * * * *

S. [DELETED]
T. [DELETED]

* * * * * * *

APPENDIX A

NOTICE

Attached hereto are the *pertinent provisions* of a cease and desist order entered against Grolier, Incorporated and certain of its subsidiaries, including Grolier Interstate, Inc. by the Federal Trade Commission, an agency of the Federal Government. Violation of any provision of this Order can result in severe monetary penalties to Grolier, Incorporated and Grolier Interstate, Inc. If you are employed by Grolier, Incorporated or any of its subsidiaries, you will be *required* to observe the provisions of this Order. Violation of any provision of this Order by an employee constitutes a violation of a federal law.

You should carefully read this Order before agreeing to any employment arrangement with Grolier, Incorporated or any of its subsidiary companies.

(President)
Grolier, Incorporated

APPENDIX B

This Appendix sets forth the methodology respondents shall employ to determine whether advertisements or promotional materials represent that a person who replies as requested may be contacted directly by a salesperson for the purpose of selling respondents' products, and the criteria for determining whether such advertisements or promotional materials comply with Paragraph II.A.

1. *Format*—Respondents shall test the comprehension level of advertisements or promotional material by conducting a mall-intercept test or an in-home survey using the questionnaires attached hereto as Exhibit 1.
2. *Sample Size*—The sample shall consist of at least 150 subjects.
3. *Demographics*—Test subjects must:

(a) be between 25 and 49 years of age;
(b) have at least one child fifteen years of age or younger living at home;

(c) have household incomes of at least $15,000 per year for 85% of the subjects tested and the remaining 15% must have household incomes of less than $15,000 per year; *provided*, that, upon respondents' request, the Division of Enforcement shall increase this figure by increments of $5,000 whenever the percentage of households earning at least the requested amount equals or exceeds the percentage of households that, according to the 1980 United States Census, have household incomes of at least $15,000 per year. The data for future changes shall be based on the most recently published edition of the *Statistical Abstract of the United States*.

4. *Location of Markets*—The interviewing will be conducted in four geographically dispersed markets. In the case of mall-intercept tests, the same central location facilities will be used wherever possible. If it is necessary to change any interviewing facility, the new facility shall have demographic characteristics similar to those of the facility it is replacing.

5. *Criteria for Acceptability of New Coupon Copy*—New promotional material copy shall comply with Paragraph II.A if at least seventy-five percent of the test subjects in both the group surveyed with household incomes in excess of $15,000 and the group with household incomes of less than $15,000 answer "yes" to question 2 of the questionnaires (Exhibit 1).

Modifications to this Appendix, including the questionnaire, may be made upon a request by respondents and the approval of the Associate Director for Enforcement.

EXHIBIT 1

MALL SCREENER

1–4
S-1

COMPREHENSION STUDY-CARD

Hello, I'm __________ from __________, a national marketing research firm. We're conducting a survey and would like to ask you a few brief questions.

A. Are you the (male/female) head of your household?

Male head of household .... 1 } (APPLY TO APPROPRIATE QUOTA)
Female head of household................ 2 }

NEITHER........../1/2/3/4/5/6/7/8/9/0/ ("X" FIRST UNUSED BOX, TERMINATE AND RE-USE.)

B. Which of the following groups best describes your age? Are you ...... (READ LIST)?

Under 25........../1/2/3/4/5/6/7/8/9/0/
("X" FIRST UNUSED BOX, TERMINATE AND RE-USE.)
25–29..........1 }
30–34..........2 }
35–39..........3 } (CONTINUE)
40–44..........4 }
45–49..........5 }

50 or over........../1/2/3/4/5/6/7/8/9/0/ ("X" FIRST UNUSED BOX, TERMINATE AND RE-USE.)

(DO NOT READ) Refused........../1/2/3/4/5/6/7/8/9/0/ ("X" FIRST UNUSED BOX, TERMINATE AND RE-USE.)

C. And, which of the following groups best describes your annual household income before taxes for 1983? Is it..........(READ LIST)?

Under $15,000 1
$15,000 - $24,999 ....2 } (APPLY TO APPROPRIATE QUOTA)
$25,000 or more 3
(DO NOT READ) Refused........../1/2/3/4/5/6/7/8/9/0/ ("X" FIRST UNUSED BOX, TERMINATE AND RE-USE)

IF OVER QUOTA - $15,000 OR MORE, "X" FIRST UNUSED BOX, TERMINATE AND RE-USE.

/1/2/3/4/5/6/7/8/9/0/

D. How many school age children, 15 years of age or younger, live in your household?

#______________________

None........../1/2/3/4/5/6/7/8/9/0/ ("X" FIRST UNUSED BOX, TERMINATE AND RE-USE.)

MALL

COMPREHENSION STUDY - CARD

MAIN QUESTIONNAIRE

(HAND RESPONDENT DRAWING CARD)

1. Now I'd like to ask you a few questions about this free drawing card.

Based on what you just read, what would you expect to happen if you filled out the card? (PROBE) What else would you expect to happen?

____

____

____

____

2. For the purpose of this research, let's suppose that you filled out the card. That is, you are interested in receiving information about the educational materials described. Would you expect to be contacted by a sales representative?

Yes..........1
No 2

(TAKE BACK DRAWING CARD)

THANK RESPONDENT AND TERMINATE.

RESPONDENT'S NAME:______________TELEPHONE #:(   ) ________________

ADDRESS: ____

CITY:___________ STATE:___________ ZIP: ________________

INTERVIEWER'S NAME:________________________ DATE: __________

In the Matter of

THOMPSON MEDICAL COMPANY, INC.

FINAL ORDER, OPINION, ETC. IN REGARD TO ALLEGED VIOLATIONS OF SECS. 5 AND 12 OF THE FEDERAL TRADE COMMISSION ACT

Docket 9149. Complaint, Feb. 5, 1981—Final Order, Nov. 23, 1984

This Final Order requires a New York City pharmaceutical company to cease, in connection with the advertising, sale or distribution of over-the-counter (OTC) health care products, using the brand name "Aspercreme" for any product that does not contain a significant amount of aspirin; or misrepresenting by any other means that aspirin is an active ingredient of such product. TV and radio advertising for "Aspercreme" must include an explicit aspirin disclaimer statement and such disclaimer must also be prominently displayed in print advertising and product labeling. The Order further bars the firm from misrepresenting the contents, validity, results or interpretations of tests or studies; and from representing, without prescribed substantiation, the speed or effectiveness of its products in the relief of minor pain and other symptoms of arthritis, bursitis, rheumatism or other musculoskeletal disorders. Additionally, the Order dismisses Paragraph 12(f) of the Complaint.

Appearances

For the Commission: *Elizabeth T. Guarino, Grace Polk Stern, Melvin H. Orlans, Randell C. Ogg, Nancy W. Warder* and *Teresa A. Hennessy.*

For the respondent: *Stuart L. Friedel, Joseph M. Burke* and *Patricia Hatry, Davis & Gilbert,* New York City; *Stephen Kurzman, Nixon, Hargrave, Devans & Doyle,* Washington, D.C.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that Thompson Medical Company, a corporation, (hereinafter "Thompson"), and Ogilvy & Mather, Inc., a corporation, (hereinafter "Ogilvy"), hereinafter sometimes referred to as respondents, have violated the provisions of the Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

PARAGRAPH 1. Thompson is a corporation organized, existing, and doing business under and by virtue of the laws of the State of New

York with its offices and principal place of business located at 919 Third Avenue, New York, New York.

Par. 2. Ogilvy is a corporation organized, existing, and doing business under and by virtue of the laws of the State of New York with its office and principal place of business located at 2 East 48th Street, New York, New York.

Par. 3. Thompson is now and has been engaged in the business of manufacturing, advertising, offering for sale, sale, and distribution of various over-the-counter health care products, including the products Aspercreme Creme Rub and Aspercreme Lotion Rub (hereinafter "Aspercreme"), products advertised to treat various disorders. In connection with the manufacture and marketing of Aspercreme, Thompson is now and has been engaged in the dissemination, publication, and distribution of advertisements and promotional material for the purpose of promoting the sale of Aspercreme for human use. As advertised, Aspercreme is a "drug" within the meaning of Section 12 of the Federal Trade Commission Act. [2]

Par. 4. Thompson causes said products when sold to be transported from its places of business in various States to purchasers located in various other States. Thompson maintains, and at all times mentioned herein has maintained, a substantial course of trade in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act.

Par. 5. Ogilvy is now, and for some time past has been, an advertising agency of Thompson. Ogilvy has prepared and placed for publication, advertising material to promote the sale of Aspercreme for human use.

Par. 6. In the course and conduct of its business, and at all times mentioned herein, Thompson has been and now is in substantial competition in or affecting commerce with corporations, firms, and individuals representing or engaged in the manufacture or marketing of health care products.

Par. 7. Ogilvy at all times mentioned herein has been and now is, in substantial competition in or affecting commerce with other advertising agencies.

Par. 8. In the course and conduct of their businesses, respondents have disseminated and caused the dissemination of certain advertisements concerning Aspercreme through the United States mail and by various means in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, including the insertion of advertisements in magazines with national circulations and the placement of advertisements with television stations with sufficient power to broadcast across state lines and into the District of Columbia.

Par. 9. Typical statements and representations in said advertisements, disseminated as previously described, but not necessarily all-inclusive, are the advertisements attached hereto as Exhibits A through H.

PAR. 10. Through the use of the advertisements referred to in Paragraphs Eight and Nine and others not specifically set forth herein, respondents represented and now represent, directly or by implication that:

a. Aspercreme contains aspirin.

b. Aspercreme is a recently discovered or developed drug product.

c. Valid studies have scientifically proven that Aspercreme is more effective than orally-ingested aspirin for the relief of arthritis, rheumatic conditions, and their symptoms. [3]

PAR. 11. In truth and in fact:

a. Aspercreme does not contain aspirin.

b. Aspercreme is not a recently discovered or developed drug product; it has been available for purchase since at least 1971 and its active ingredient has been in existence since at least 1954.

c. No valid studies have scientifically proven that Aspercreme is more effective than orally-ingested aspirin for the relief of arthritis, rheumatism, and their symptoms.

Therefore, the representations, set forth in Paragraph Ten were and are false, misleading, or deceptive; and the advertisements referred to in Paragraphs Eight and Nine were and are misleading in material respects, and constituted and now constitute false advertisements.

PAR. 12. Through the use of the advertisements referred to in Paragraph Eight and Nine and others not specifically set forth herein, respondents represented, and now represent, directly or by implication that:

a. Aspercreme is an effective drug for the relief of minor arthritis and its symptoms.

b. Aspercreme is as effective a drug as orally-ingested aspirin for the relief of minor arthritis and its symptoms.

c. Aspercreme is a more effective drug than orally-ingested aspirin for the relief of minor arthritis and its symptoms.

d. Aspercreme is an effective drug for the relief of rheumatic conditions and their symptoms.

e. Aspercreme acts by directly penetrating through the skin to the site of the arthritic disorder.

f. The use of Aspercreme will result in no side effects.

PAR. 13. At the time of the first and subsequent disseminations of the representations contained in Paragraph Twelve respondents did not possess and rely upon a reasonable basis for making those representations. Therefore, the dissemination of the said representations as alleged constituted, and now constitutes, unfair or deceptive acts or practices in or affecting commerce.

Par. 14. Through the use of the advertisements referred to in Paragraphs Eight and Nine and others not specifically set forth herein respondents have represented and now represent [4] directly or by implication that they possessed and relied upon a reasonable basis for the representations set forth in Paragraph Twelve at the time such representations were made.

Par. 15. In truth and in fact, respondents did not possess and rely upon a reasonable basis for the representations set forth in Paragraph Twelve at the time such representations were made. Therefore, the representations set forth in Paragraph Fourteen were and are false, misleading or deceptive.

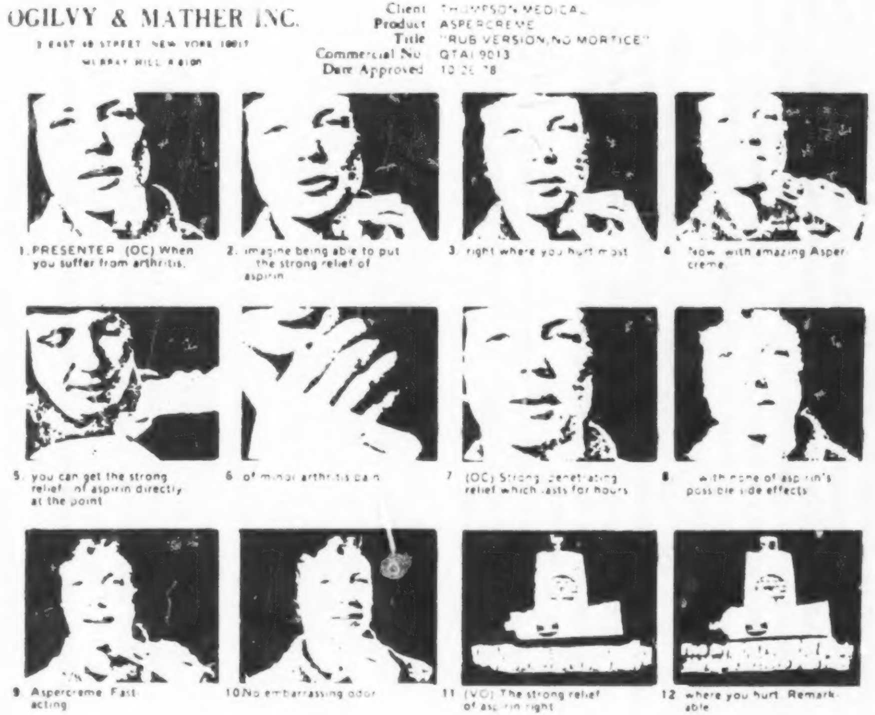
Par. 16. Through the use of the trade name "Aspercreme" in advertising, labels and promotional materials, respondents have represented and now represent that the product "Aspercreme" contains aspirin.

Par. 17. In truth and in fact, "Aspercreme" contains no aspirin. Therefore, the representation in Paragraph Sixteen was and is false, misleading, deceptive or unfair, and the use of the trade name "Aspercreme" to describe a product which contains no aspirin constituted and now constitutes an unfair or deceptive act or practice in or affecting commerce,

Par. 18. The use by respondents of the aforesaid unfair or deceptive representations and the dissemination of the aforesaid false advertisements has had, and now has, the capacity and tendency to mislead members of the consuming public into the erroneous and mistaken belief that said representations were and are true.

Par. 19. The acts and practices of respondents, as herein alleged, including the dissemination of the aforesaid false advertisements, were and are all to the prejudice and injury of the public and of respondents' competitors and constituted, and now constitute, unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce in violation of Sections 5 and 12 of the Federal Trade Commission Act, as amended.

EXHIBIT A



OGILVY & MATHER INC.

2 EAST 48 STREET, NEW YORK 10017

MURRAY HILL 8-6100

Client THOMPSON MEDICAL
Product ASPERCREME
Title "RUB VERSION, NO MORTICE"
Commercial No QTA1 9013
Date Approved 10/26/78

1. PRESENTER (OC) When you suffer from arthritis,

2. imagine being able to put the strong relief of aspirin

3. right where you hurt most

4. Now, with amazing Aspercreme

5. you can get the strong relief of aspirin directly at the point

6. of minor arthritis pain

7. (OC) Strong, penetrating relief which lasts for hours

8. with none of aspirin's possible side effects

9. Aspercreme. Fast-acting

10. No embarrassing odor

11. (VO) The strong relief of aspirin right

12. where you hurt. Remarkable.

EXHIBIT B

OGILVY & MATHER INC.

2 EAST 48 STREET, NEW YORK 10017
MURRAY HILL 8-6100

Client: THOMPSON MEDICAL
Product: ASPERCREME
Title: "VISIBLE MEN"
Commercial No.: QTAI 9033
Date Approved: 3/30/79

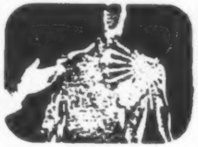
1. PRESENTER: (OC) When you suffer from arthritis,

2. imagine putting the strong relief of aspirin right where you hurt.

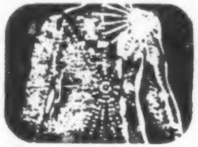
3. Aspercreme is an odorless rub

4. which concentrates the relief of aspirin

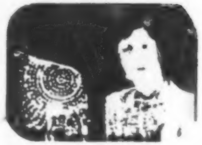
5. When you take regular aspirin,



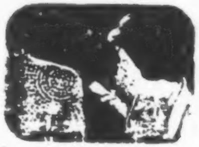
6. it goes throughout your body like this.



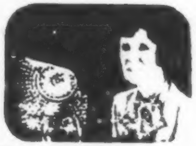
7. But, in seconds,



8. Aspercreme starts concentrating all the temporary relief of two aspirin



9. directly at the point of minor arthritis pain.



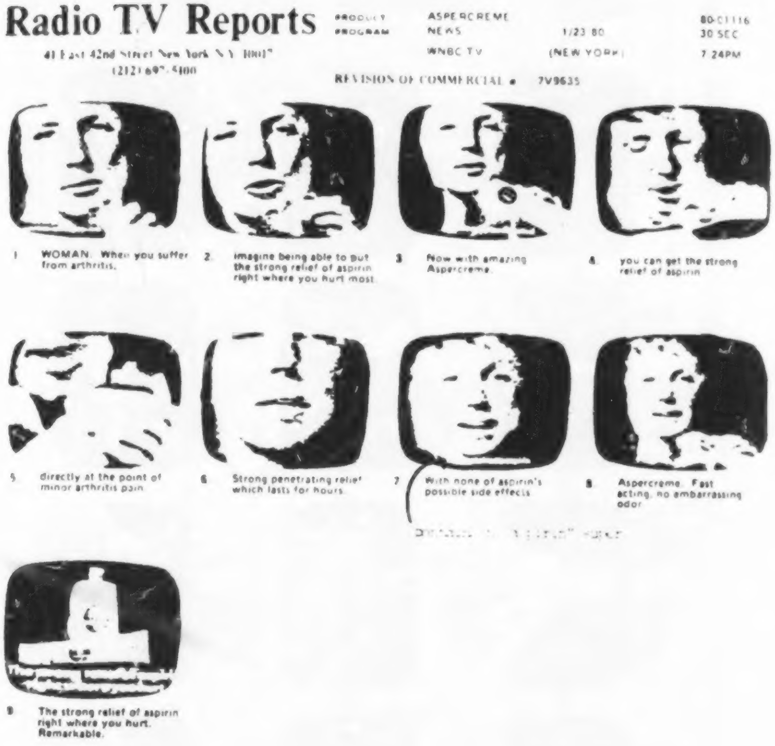
10. Strong, concentrated relief.

11. VO: Aspercreme.

The strong relief of aspirin right where you hurt

12. The strong relief of aspirin right where you hurt

EXHIBIT C



Radio TV Reports

41 East 42nd Street New York N.Y. 10017
(212) 697-5100

PRODUCT ASPERCREME 80-C1116
PROGRAM NEWS 1/23/80 30 SEC
WNBC TV (NEW YORK) 7:24PM

REVISION OF COMMERCIAL # 7V9635

1 WOMAN: When you suffer from arthritis,

2. imagine being able to put the strong relief of aspirin right where you hurt most.

3 Now with amazing Aspercreme,

4. you can get the strong relief of aspirin

5 directly at the point of minor arthritis pain.

6 Strong penetrating relief which lasts for hours.

7 With none of aspirin's possible side effects.

8 Aspercreme. Fast acting, no embarrassing odor.

9 The strong relief of aspirin right where you hurt. Remarkable.

ALSO AVAILABLE IN COLOR VIDEO TAPE CASSETTE

EXHIBIT D

OGILVY & MATHER INC.

2 EAST 48 STREET, NEW YORK 10017
MURRAY HILL 8-6100

Client: THOMPSON MEDICAL
Product: ASPERCREME
Title: "VISIBLE MEN"
Commercial No.: QTAI 9033
Date Approved: 3/30/79

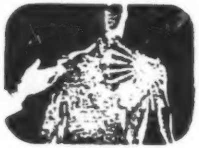
1. PRESENTER: (OC) When you suffer from arthritis,

2. imagine putting the strong relief of aspirin right where you hurt.

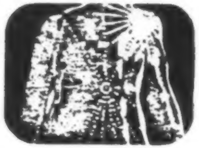
3. Aspercreme is an odorless rub

4. which concentrates the relief of aspirin.

5. When you take regular aspirin,



6. it goes throughout your body like this.



7. But, in seconds,

8. Aspercreme starts concentrating all the temporary relief of two aspirin

9. directly at the point of minor arthritis pain.

[illegible] "aspirin" super

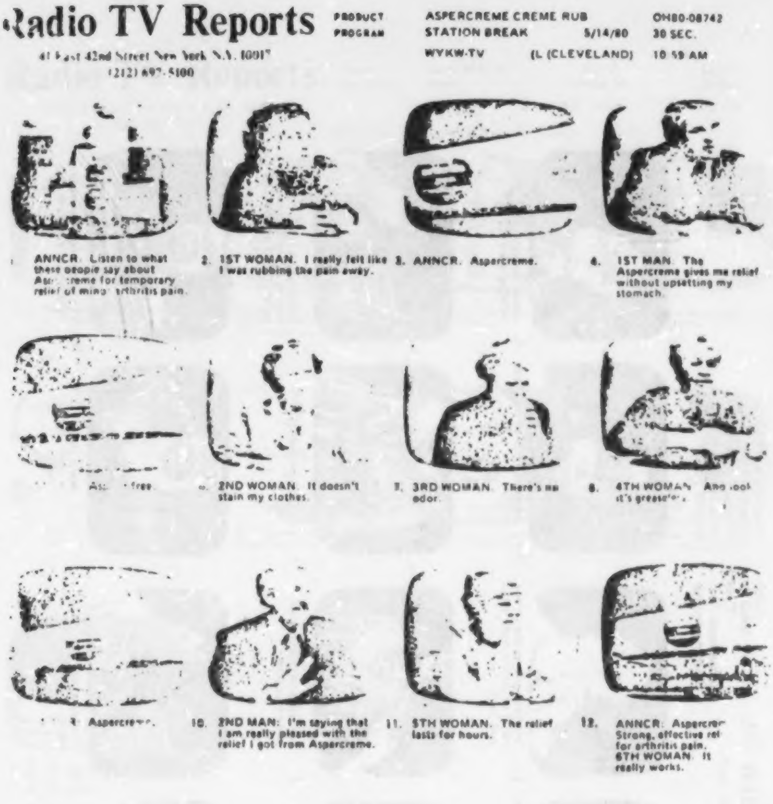
10. Strong, concentrated relief.

11. VO: Aspercreme.

The strong relief of aspirin right where you hurt

12. The strong relief of aspirin right where you hurt.

EXHIBIT E



Radio TV Reports

41 East 42nd Street New York N.Y. 10017
(212) 697-5100

PRODUCT ASPERCREME CREME RUB OH80-08742
PROGRAM STATION BREAK 5/14/80 30 SEC.
WYKW-TV (L (CLEVELAND) 10 59 AM

1. ANNCR: Listen to what these people say about Aspercreme for temporary relief of minor arthritis pain.

2. 1ST WOMAN: I really felt like I was rubbing the pain away.

3. ANNCR: Aspercreme.

4. 1ST MAN: The Aspercreme gives me relief without upsetting my stomach.

[illegible] As[illegible] free.

6. 2ND WOMAN: It doesn't stain my clothes.

7. 3RD WOMAN: There's no odor.

8. 4TH WOMAN: And look it's greaseless.

[illegible] R: Aspercreme.

10. 2ND MAN: I'm saying that I am really pleased with the relief I got from Aspercreme.

11. 5TH WOMAN: The relief lasts for hours.

12. ANNCR: Aspercre[illegible] Strong, effective rel[illegible] for arthritis pain.
6TH WOMAN: It really works.

ALSO AVAILABLE IN COLOR VIDEO-TAPE CASSETTE

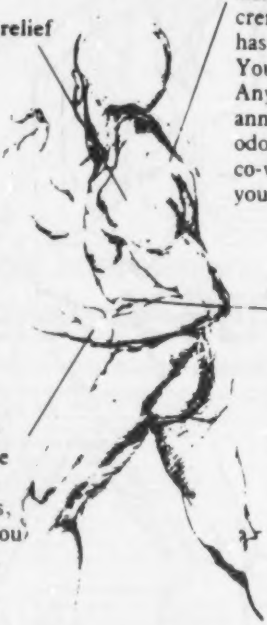
EXHIBIT F

At last! A remarkable breakthrough for arthritis pain: Aspercreme.

Aspercreme is an effective arthritis medicine which concentrates all the strong relief of aspirin directly at the point of pain.

1 Strong concentrated relief Aspercreme™ pinpoints relief where you hurt. Aspirin tablets go throughout your body. But Aspercreme concentrates the relief of an effective aspirin-like analgesic directly at the point of arthritis pain — where you need it the most.

2 Fast relief for minor arthritis pain. Aspercreme penetrates deep into painful areas — fingers, elbows, knees, back, shoulders. You get deep relief in minutes. Aspercreme works faster than aspirin because you rub it in right where you hurt.



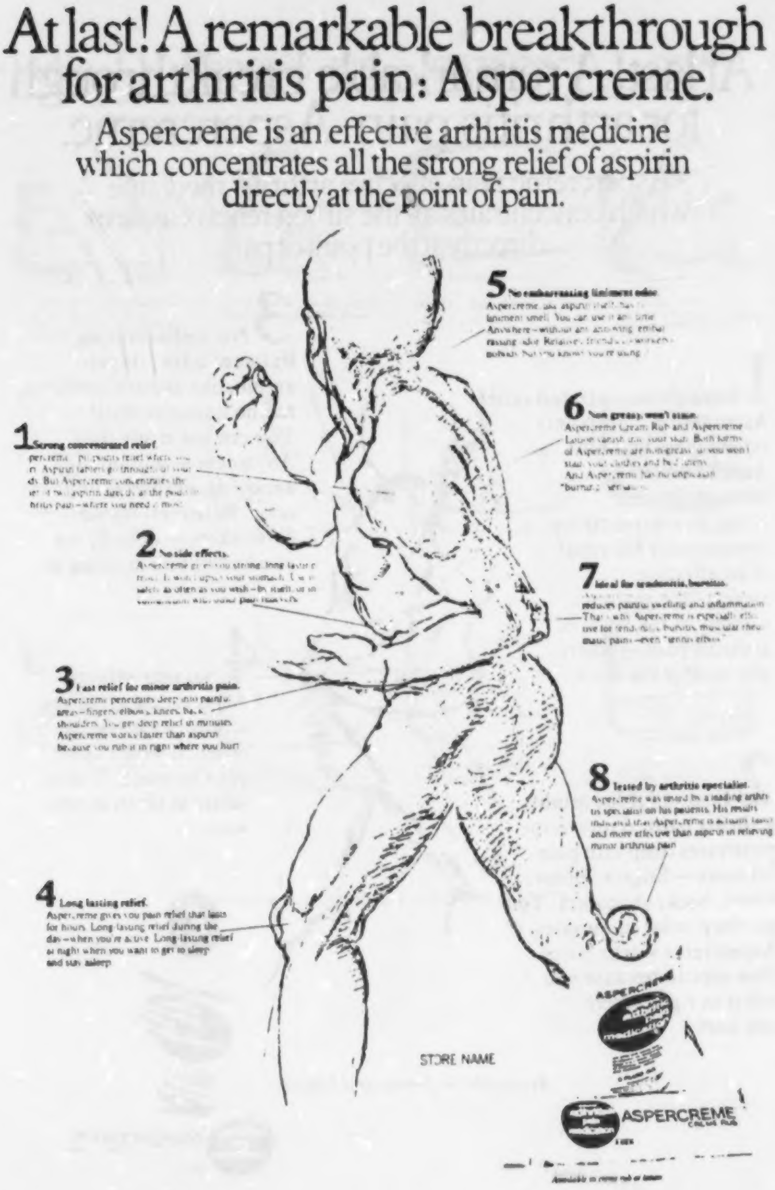
3 No embarrassing liniment odor. Aspercreme, like aspirin itself, has no liniment smell. You can use it any time. Anywhere — without any annoying, embarrassing odor. Relatives, friends, co-workers — nobody but you knows you're using it!

4 No side effects. Aspercreme gives you strong, long-lasting relief. It won't upset your stomach. Use it safely as often as you wish.

Available in creme and lotion

ASPERCREME

EXHIBIT G



At last! A remarkable breakthrough for arthritis pain: Aspercreme.

Aspercreme is an effective arthritis medicine which concentrates all the strong relief of aspirin directly at the point of pain.

1 Strong concentrated relief. Aspercreme pinpoints relief where you need it. Aspirin tablets go throughout your body. But Aspercreme concentrates the relief of two aspirin directly at the point of arthritis pain—where you need it most.

2 No side effects. Aspercreme gives you strong, long lasting relief. It won't upset your stomach. Use it safely as often as you wish—by itself, or in combination with other pain relievers.

3 Fast relief for minor arthritis pain. Aspercreme penetrates deep into painful areas—fingers, elbows, knees, back, shoulders. You get deep relief in minutes. Aspercreme works faster than aspirin because you rub it in right where you hurt.

4 Long lasting relief. Aspercreme gives you pain relief that lasts for hours. Long-lasting relief during the day—when you're active. Long-lasting relief at night when you want to get to sleep and stay asleep.

5 No embarrassing liniment odor. Aspercreme, like aspirin itself, has no liniment smell. You can use it any time. Anywhere—without any annoying, embarrassing odor. Relatives, friends, co-workers, nobody but you knows you're using it.

6 Non greasy, won't stain. Aspercreme Cream Rub and Aspercreme Lotion vanish into your skin. Both forms of Aspercreme are nongreasy, so you won't stain your clothes and bed linens. And Aspercreme has no unpleasant "burning" sensation.

7 Ideal for tendonitis, bursitis. [illegible] reduces painful swelling and inflammation. That's why Aspercreme is especially effective for tendonitis, bursitis, muscular rheumatic pains—even "tennis elbow."

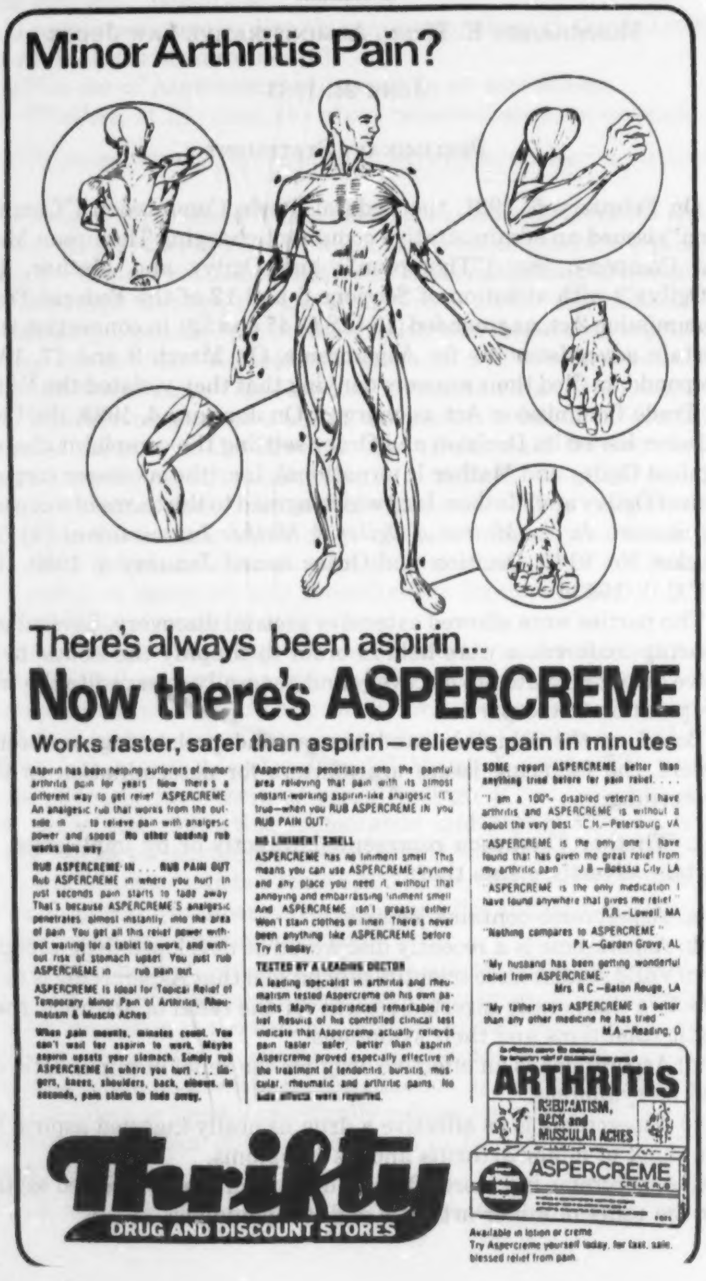
8 Tested by arthritis specialist. Aspercreme was tested by a leading arthritis specialist on his patients. His results indicated that Aspercreme is actually faster and more effective than aspirin in relieving minor arthritis pain.

STORE NAME

ASPERCREME
CREME RUB

Available in creme rub or lotion

EXHIBIT H



Minor Arthritis Pain?

There's always been aspirin...

Now there's ASPERCREME

Works faster, safer than aspirin—relieves pain in minutes

Aspirin has been helping sufferers of minor arthritis pain for years. Now there's a different way to get relief. ASPERCREME. An analgesic rub that works from the outside in . . . to relieve pain with analgesic power and speed. No other leading rub works this way.

RUB ASPERCREME IN . . . RUB PAIN OUT Rub ASPERCREME in where you hurt. In just seconds pain starts to fade away. That's because ASPERCREME'S analgesic penetrates almost instantly into the area of pain. You get all this relief power without waiting for a tablet to work, and without risk of stomach upset. You just rub ASPERCREME in . . . rub pain out.

ASPERCREME is ideal for Topical Relief of Temporary Minor Pain of Arthritis, Rheumatism & Muscle Aches.

When pain mounts, minutes count. You can't wait for aspirin to work. Maybe aspirin upsets your stomach. Simply rub ASPERCREME in where you hurt . . . fingers, knees, shoulders, back, elbows. In seconds, pain starts to fade away.

Aspercreme penetrates into the painful area relieving that pain with its almost instant-working aspirin-like analgesic. It's true—when you RUB ASPERCREME IN you RUB PAIN OUT.

NO LINIMENT SMELL

ASPERCREME has no liniment smell. This means you can use ASPERCREME anytime and any place you need it, without that annoying and embarrassing liniment smell. And ASPERCREME isn't greasy either. Won't stain clothes or linen. There's never been anything like ASPERCREME before. Try it today.

TESTED BY A LEADING DOCTOR

A leading specialist in arthritis and rheumatism tested Aspercreme on his own patients. Many experienced remarkable relief. Results of his controlled clinical test indicate that Aspercreme actually relieves pain faster, safer, better than aspirin. Aspercreme proved especially effective in the treatment of tendonitis, bursitis, muscular, rheumatic and arthritic pains. No side effects were reported.

SOME report ASPERCREME better than anything tried before for pain relief. . . .

"I am a 100% disabled veteran. I have arthritis and ASPERCREME is without a doubt the very best." C.H.—Petersburg, VA

"ASPERCREME is the only one I have found that has given me great relief from my arthritic pain." J.B.—Bossier City, LA

"ASPERCREME is the only medication I have found anywhere that gives me relief."
R.R.—Lowell, MA

"Nothing compares to ASPERCREME."
P.K.—Garden Grove, AL

"My husband has been getting wonderful relief from ASPERCREME."
Mrs. R.C.—Baton Rouge, LA

"My father says ASPERCREME is better than any other medicine he has tried."
M.A.—Reading, O

Thrifty
DRUG AND DISCOUNT STORES

Available in lotion or creme.
Try Aspercreme yourself today, for fast, safe, blessed relief from pain.

INITIAL DECISION BY

MONTGOMERY K. HYUN, ADMINISTRATIVE LAW JUDGE

JUNE 24, 1983

PRELIMINARY STATEMENT

On February 5, 1981, the Federal Trade Commission ("Commission") issued an administrative complaint charging Thompson Medical Company, Inc. ("Thompson") and Ogilvy and Mather, Inc. ("Ogilvy") with violation of Sections 5 and 12 of the Federal Trade Commission Act, as amended (15 U.S.C. 45 and 52), in connection with certain advertisements for Aspercreme. On March 9 and 17, 1981, respondents filed their answers denying that they violated the Federal Trade Commission Act as charged. On January 4, 1983, the Commission issued its Decision and Order settling the complaint charges against Ogilvy and Mather International, Inc. (the successor corporation of Ogilvy and Mather, Inc.) which agreed to the terms of a consent agreement. *In the Matter of Ogilvy & Mather International,* [2] *Inc.,* Docket No. 9149, Decision and Order issued January 4, 1983. [101 F.T.C. 1 (1983)]

The parties were allowed extensive pretrial discovery. Several prehearing conferences were held in order to simplify the issues, to resolve disputes related to discovery and generally to expedite the trial preparation of the parties.

Based on the complaint and answer and prehearing conference orders, the following issues are matters for determination in this proceeding:

1. Whether Thompson represented, directly or by implication, in certain advertisements that:

(a) Aspercreme contains]aspirin.

(b) Aspercreme is a recently discovered or developed drug product.

(c) Valid studies have scientifically proven that Aspercreme is more effective than orally-ingested aspirin for the relief of arthritis, rheumatic conditions and their symptoms.

(d) Aspercreme is an effective drug for the relief of minor arthritis and its symptoms.

(e) Aspercreme is as effective a drug as orally-ingested aspirin for the relief of minor arthritis and its symptoms.

(f) Aspercreme is a more effective drug than orally-ingested aspirin for the relief of minor arthritis and its symptoms.

(g) Aspercreme is an effective drug for the relief of rheumatic conditions and their symptoms.

(h) Aspercreme acts by directly penetrating through the skin to the site of the arthritis disorder. [3]

(i) The use of Aspercreme will result in no side effects.

2. Whether, at the time, the above representations were made:

(a) Representations 1 (a) through (c) were false, misleading or deceptive.

(b) Respondent possessed and relied on a reasonable basis for representations 1 (d) through (i) and whether the making of such representations without a reasonable basis was false, misleading or deceptive.

3. Whether, through the use of the brand name "Aspercreme" in advertising, labels and promotional materials, respondent represented that the product "Aspercreme" contains aspirin and whether the use of the brand name "Aspercreme" is false, misleading or deceptive.

4. Whether respondent's use of the aforesaid unfair or deceptive representations and the dissemination of aforesaid false advertisements have the capacity and tendency to mislead consumers into the erroneous belief that these representations are true and into the purchase of substantial quantities of Aspercreme by reason of said erroneous belief and thus constitute unfair methods of competition and unfair or deceptive acts proscribed by Sections 5 and 12 of the Federal Trade Commission Act,

The evidentiary hearings for the presentation of complaint counsel's case-in-chief began on July 5, 1982 and ended on July 23, 1982. Defense hearings began on August 23, 1982 and ended on January 19, 1983, including a recess from September 9 to October 4, 1982. The evidentiary record was closed on [4] March 7, 1983.[1] The parties simultaneously filed their proposed findings of fact, conclusions of law, order and supporting memoranda and replies thereto. Some thirty witnesses, including nineteen expert witnesses, testified. Transcripts of hearings number some 6,500 pages. Some 200 documentary exhibits, including numerous consumer studies and medical-scientific studies, were received into evidence.

The proposed findings and conclusions submitted by the parties and their arguments in support thereof have been given careful consideration by me and to the extent not adopted by this Initial Decision, in the form proposed or in substance, are rejected as not supported by the evidence or as immaterial. Any motion appearing on the record not heretofore or hereby specifically ruled upon either directly or by the necessary effect of the conclusions in this Initial Decision are hereby denied.

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[1] By order dated April 5, 1983, the Commission extended the due date of this Initial Decision to June 24, 1983.

Upon consideration of the entire record in this proceeding and having considered the demeanor of the witnesses, I make the following findings of fact and conclusions of law and order based on the record considered as a whole:[2] [5]

FINDINGS OF FACT

I. RESPONDENT, JURISDICTION AND OTHER GENERAL FINDINGS

1. Thompson Medical Company, Inc. ("Thompson") is a corporation organized, existing and doing business under and by virtue of the laws of the State of New York with its offices and principal place of business located at 919 Third Avenue, New York, New York (Answer of Thompson, Paragraph 1).

2. Thompson is now and has been engaged in the distribution, advertising, offering for sale, and sale of various over-the-counter drug products, including the products Aspercreme Creme Rub and Aspercreme Lotion Rub ("Aspercreme") (Answer of Thompson, Paragraph 3) and certain appetite control drugs (CX 45F, Admission No. 81). In connection with the marketing of Aspercreme, Thompson is now and has been engaged in the dissemination, publication, and distribution of advertisements and promotional material for the purpose of promoting the sale of Aspercreme for human use. As advertised, Aspercreme is a "drug" within the meaning of Section 12 of the Federal Trade Commission Act (Answer of Thompson, Paragraph 3).

3. In the course and conduct of its business, Thompson causes Aspercreme, when sold, to be transported from its place of business to purchasers located in various other States of the United States and the District of Columbia. Thompson maintains, and at all times relevant to this proceeding has maintained, a substantial course of trade in these products, in or affecting commerce, as "commerce" is defined

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[2] For the purposes of this Initial Decision, the following abbreviations were used:

F. - Finding of Fact in this Decision
CPF - Complaint Counsel's Proposed Findings
CB - Complaint Counsel's Memorandum In Support of Proposed Findings
CRB - Complaint Counsel's Memorandum In Support of Reply Findings
RPF - Respondent's Proposed Findings
RB - Respondent's Memorandum In Support of Proposed Findings
RRB - Respondent's Reply Memorandum
Tr. - Transcript of hearings, sometimes preceded by the name of the witness
CX - Complaint Counsel's documentary exhibit
RX - Respondent's documentary exhibit
CPX - Complaint Counsel's physical exhibit
RPX - Respondent's physical exhibit
Comp. - Complaint
Ans. - Answer

in the Federal Trade Commission Act. The volume of such business has been substantial (Answer of Thompson, Paragraph 4; F. 74–76, *infra*).

4. In the course and conduct of its business, and, at all times relevant to this proceeding, Thompson has been and is now in substantial competition in or affecting commerce with corporations, firms, and individuals representing or engaged in the manufacture or marketing of health care products (Answer of Thompson, Paragraph 6).

5. In the course and conduct of its business, Thompson has disseminated and caused the dissemination of certain advertisements concerning Aspercreme through the United States mail and by various means in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, including, but not limited to, the insertion of advertisements in magazines with national circulations and the placement of advertisements with **[6]** television stations with sufficient power to broadcast across states lines and into the District of Columbia (Answer of Thompson, Paragraph 8; F. 73–75, *infra*).

6. Aspercreme is a topical cream or lotion rub, the active ingredient of which is 10% triethanolamine salicylate ("TEA/S") (*See* RX 276–84; RPX 3–6; CPX 5–7). TEA/S is also known as trolamine salicylate. The package direction for its use advises that the user massage it into painful areas until thoroughly absorbed into skin, three or four times daily (*e.g.*, RX 279).

7. In a report published on December 4, 1979, the Food and Drug Administration's Advisory Review Panel on OTC Topical Analgesic, Antirheumatic, Otic, Burn, and Sunburn Prevention and Treatment Drug Products ("FDA OTC External Analgesic Panel") concluded that TEA/S "is safe but that there are insuffficient data available to permit final classification of its effectiveness for use as an OTC external analgesic" for labeling purposes (CX 269, p. 69,856). The Panel placed TEA/S among the Category III ingredients and recommended that during the testing period provided to demonstrate effectiveness, the ingredient TEA/S may bear the labeling provided for topical analgesics (*Id.*).

8. In a notice of proposed rulemaking published on February 8, 1983, the FDA published a tentative final monograph on OTC external analgesic drug products, which in effect adopted the FDA Advisory Panel's conclusions and recommendations regarding TEA/S as a topical analgesic (CX 443).

9. By Citizens Petition dated November 24, 1981 and filed with the FDA (RX 366), Thompson requested the Commission to reopen the administrative record and to receive new data being submitted by Thompson and urged that 10% TEA/S (Aspercreme) be placed by the FDA in Category I as an effective topical analgesic. Although there

has not been a final disposition of Thompson's November 1981 Petition and subsequent correspondence by the FDA, the FDA's proposed rule for OTC external analgesic drug products (CX 443) appears to have considered substantially all of the studies in evidence in this proceeding and to have adopted the OTC External Analgesic Panel's conclusions and recommendations regarding TEA/S. As reflected in this record, it is unlikely that the FDA will reverse its position with respect to topical TEA/S as a result of its review of the pending Thompson submissions (*See* F. 393–400, *infra*). However, respondent states that, under the FDA's monograph procedures for OTC external analgesic drug products, respondent is permitted to continue marketing Aspercreme for an interim period until April 9, 1984, pending development and review of "evidence that will permit final classification of the [7] effectiveness of TEA/S, "presumably including two or more well-controlled clinical trials (RB 18).

II. EXPERT WITNESSES WHO TESTIFIED REGARDING MARKETING AND MEDICAL/SCIENTIFIC ISSUES

10. Complaint counsel called Drs. Joel B. Cohen and Ann Silny on the issues related to advertising, marketing and consumer psychology, and Drs. John Adriani and Sanford H. Roth on the medical/scientific issues in this case.

A. *John Adriani, M.D.*

11. Dr. John Adriani is a Professor of Pharmacology at Louisiana State University Medical School, and Clinical Professor of Oral Surgery (Anesthesiology) at the Louisiana State University School of Dentistry. He is also Director of Research, in the Department of Anesthesiology, Louisiana State University Medical School and at Charity Hospital, in New Orleans, Louisiana (Adriani, Tr. 1128). Dr. Adriani is a respected researcher in the field of analgesics (O'Brien, Tr. 3736–37; Silverman, Tr. 2340). He previously taught physiology and pharmacology as pertains to anesthetic drugs and and did anesthesia research at New York University College of Medicine (Adriani, Tr. 1129). As a practicing physician, Dr. Adriani organized a pain clinic at Charity Hospital in New Orleans. His patients include those suffering from rheumatic and other diseases (Adriani, Tr. 1141). Dr. Adriani is a consultant to the Food and Drug Administration and has served on two advisory panels on OTC drugs, including the OTC External Analgesics Panel which evaluated analgesic, antirheumatic, otic, protectant and sunscreen products, including TEA/S, the active ingredient in Aspercreme (Adriani, Tr. 1130, 1135–36, 1147–48). He is also a consultant to the State of Louisiana Governor's Formulary Committee which admits certain drugs onto a list that the hospitals will stock

and supply to private patients (Adriani, Tr. 1136). Dr. Adriani has served as an advisor and consultant to a number of pharmaceutical companies, including Norwich-Eaton and Cetilyte Laboratories. He also has done consulting work involving the testing of ether and different narcotics and the stability of anesthetics with the presence of soda lime fcr pharmaceutical firms such as Squibb and Malinckradt (Adriani, Tr. 1138–39). Dr. Adriani has also conducted studies which evaluated certain pain-relieving drugs for pharmaceutical firms, including Darvon and Demerol (Adriani, Tr. 1138–40). Dr. Adriani himself has [8] been personally involved in well over 100 clinical studies (Adriani, Tr. 1144).

12. Dr. Adriani is a Fellow in the American College of Clinical Pharmacology and the American Society for Clinical Pharmacology and Therapeutics (Adriani, Tr. 1131–32). He is a Board-certified member of the American Board of Anesthesiology. For 10 years, he was a member of the Council on Drugs of the American Medical Association, serving as Chairman of the Council for a period of three years (Adriani, Tr. 1133). In addition, Dr. Adriani belongs to numerous research societies, including the Southern Society for Clinical Research and the National Society for Medical Research (Adriani, Tr. 1129–31). He has served in both elected and appointed positions on several scientific and educational committees. He is a member of the Society of Experimental Biology and Medicine, the International Congress of Pharmacology, and served on the Advisory Committee to Commissioner Larrick of the Food and Drug Administration from 1963 to 1965. Dr. Adriani was Chairman of the Advisory Committee of the Food and Drug Administration on Anesthetic and Respiratory Drugs, and a member of the Scientific Review Panel on publication of the Book, *Drug Interactions,* published by the American Pharmaceutical Association (Adriani, Tr. 1130).

13. Dr. Adriani has authored thirteen books covering such areas as drugs used for stimulation, anesthesia, and sedation, pain-relieving drugs, drugs given prophylactically, and muscle relaxants (Adriani, Tr. 1143–44). Of the approximately 600 articles he has published, half are scientific papers relating to research work and approximately 200 of them involved the clinical testing of drugs. A great many of these articles have been published in peer-reviewed scientific journals, including *Anesthesia and Anesthesiology, Clinical Pharmacology and Therapeutics,* the *Journal of Experimental Medicine and Biology,* and the *Journal of the American Medical Association* (Adriani, Tr. 1146). Dr. Adriani has served as editor and reviewer of articles on pain-relieving drugs or anesthetics for numerous scientific magazines and journals, and has edited over thirty textbooks and resource works on anesthesia (Adriani, Tr. 1142; CX 368W–X). He was Editor-in-Chief of

the *1971 AMA Drug Evaluations* and wrote approximately ten chapters of the book, including sections on strong analgesics and mild analgesics (Adriani, Tr. 1132–35). Dr. Adriani has appeared as an expert witness in a number of legal proceedings and before Congressional committees, and has testified in malpractice and product liability cases as well. Most of these cases involved pain-relieving drugs (Adriani, Tr. 1140). He also served as an expert witness in a product liability case concerning Benzocaine (Adriani, Tr. 1138). **[9]**

14. Dr. Adriani has received numerous awards and honors. Among these are the Distinguished Service Award of the American Society of Anesthesiologists and the Distinguished Service Award of the International Anesthesia Research Society. He received the Gold Medal For Distinguished Achievements in Medicine of an International Scope, from the Columbia University Alumni Association. He also received the Ralph M. Waters Medal, which in anesthesiology is comparable to the Nobel Prize, and was invited to donate his personal papers and letters to the National Library of Medicine, at the National Institutes of Health (CX 368Q). Dr. Adriani received the highest honor awarded to a civilian by the Italian Government, for his activities in medicine. He also received the Gaston Labat award which is given to physicians who contribute to the development of regional anesthesia. Dr. Adriani received this award in connection with his investigative work in local anesthetics and different techniques in nerve blocking (Adriani, Tr. 1137–38).

15. Based on his background, training, experience and familiarity with the literature, Dr. Adriani is eminently qualified as an expert in clinical pharmacology, topical analgesics, and in the evaluation of the safety and efficacy of analgesic drugs.

B. *Dr. Joel B. Cohen*

16. Dr. Joel B. Cohen is Chairman of the Marketing Department and a Professor of Marketing at the University of Florida where he also serves ad Director of the Center of Consumer Research (Cohen, Tr. 82). It conducts theoretical and applied research on consumer behavior, focused primarily on consumer information processing and decisionmaking (Cohen, Tr. 83). Dr. Cohen's teaching responsibilities are almost entirely in the consumer behavior area (Cohen, Tr. 85). Dr. Cohen holds a Ph.D. from U.C.L.A. in Marketing with a minor in Social Psychology. In 1966, he joined the faculty of the University of Illinois where he taught consumer behavior, behavioral science, marketing research and graduate level research design courses (Cohen, Tr. 87). From 1972–1974, Dr. Cohen served as Director of the Social and Behavioral Science Division of National Analysts, a leading marketing research and social science research organization (Cohen, Tr.

93–94). Dr. Cohen has been working in the area of consumer research and information processing for more than seventeen years. His primary areas of expertise are in consumer information processing, the study of consumer attitudes and cognition (what consumers have learned and believe), mass communication, and research design questions and measurement **[10]** (Cohen, Tr. 92). Over the years, Dr. Cohen has done consulting for both industry and governmental agencies (Cohen, Tr. 93–94). As consultant to the National Academy of Sciences Panel on the Impact of Drug Use and Misuse, he advised the panel regarding research design questions which could be used to evaluate the success of any advertising program which might be developed to combat drug abuse (Cohen, Tr. 95–96). More recently, he did consulting work for R.J. Reynolds relating to the processes through which advertising leads to changed cognitions and attitudes (Cohen, Tr. 96). Dr. Cohen was chief witness on advertising for Senator Packwood's Commerce Committee with respect to how cigarette warning information works. Dr. Cohen has been a consultant to the Federal Trade Commission since 1974.

17. Dr. Cohen is a member of the Association for Consumer Research. He is a member of the American Marketing Association and served as Chairman of their 1975 National Conference. Dr. Cohen is a member of the American Psychological Association and has chaired a number of professional symposia and workshops on consumer information processing (Cohen. Tr. 88–90, 98). While Dr. Cohen's work has concentrated on consumer behavior, he has presented papers at various conferences dealing with advertising, attitude measurement and applied projects in marketing and advertising (Cohen, Tr. 87–88). Dr. Cohen has authored a book, *Behavioral Science Foundations of Consumer Behavior,* and numerous articles and papers in the field of consumer behavior and attitudes (Cohen, Tr. 87–88; CX 36B–F). Dr. Cohen is a permanent member of the editorial boards of the *Journal of Consumer Research* and the *Journal of Marketing.* He is an editorial consultant for other journals in psychology and marketing including the *Journal of Applied Psychology,* the *Journal of Experimental Psychology,* the *Journal of Marketing Research, Economic Development and Cultural Change,* and *Population and Environments: Behavioral and Social Issues.* The types of articles Dr. Cohen reviews for the various journals include those in the areas of consumer information processing, advertising issues, measurement of persuasion, and particularly articles on processes through which advertising is supposed to affect a consumer's preferences and subsequent decisions (Cohen, Tr. 90–91). Dr. Cohen is well qualified as an expert in consumer information processing and analysis of consumer research.

C. *Sanford H. Roth, M.D.*

18. Dr. Sanford H. Roth currently serves as Medical Director of the Arthritis Program at St. Luke's Hospital Medical Center in Phoenix, Arizona, and has extensive experience in the [11] field of rheumatology and has been involved in clinical research relating to analgesic and anti-inflammatory drugs (Roth, Tr. 1488, 1499–1500, 1501–03, 1512). Dr. Roth's experience includes more than seventeen years of clinical practice with patients suffering from rheumatoid diseases, musculoskeletal disorders, and complications of osteoarthritis as well as considerable research in the areas of anti-arthritic, anti-inflammatory, analgesic and immuno modulating drugs (Roth, Tr. 1500–05). Dr. Roth has been involved in multiple research efforts comparing aspirin to nonsteroidal anti-inflammatory drugs (Roth, Tr. 1500). His former association with the Phoenix Arthritis Center focused on the treatment of rheumatic disorders, but also involved clinical investigations (Roth, Tr. 1506–07). He is a well-known and respected rheumatologist (O'Brien, Tr. 3736–37; Ehrlick, Tr. 4038). Dr. Roth has served as a consultant to the FDA and was an expert witness in rheumatology before the Arthritis Advisory Committee (Roth, Tr. 1495). He participated in the development of new FDA guidelines on package inserts, and worked with the National Institute of Health creating the American Rheumatism Association Medical Information System ("ARAMIS") which is now the world's largest repository of rheumatic disease, clinical data. Dr. Roth presently serves as co-director and principal investigator for the Phoenix data bank (Roth, Tr. 1495–97). Dr. Roth has served as a consultant to various pharmaceutical companies including Hoechst-Roussel Company, Pfizer Drug Company, Syntex Drug Company, Perdue Frederick and the MMM RIKER Company (Roth, Tr. 1497–98). This work involved the clinical evaluation of drugs and, in particular, salicylates (including the development of a nonacetylated salicylate for Perdue Frederick), work with teaching programs for the Riker Company in connection with another nonacetylated salicylate, and involvement with Bristol Myers relating to the gastrointestinal safety of a highly buffered aspirin product (Roth, Tr. 1499–1500).

19. Dr. Roth has served as Chairman of the Anti-Rheumatic Drug Therapy Study Group of the American Rheumatism Association and is currently a member of other professional associations with particular interest in rheumatology (Roth, Tr. 1493). He is affiliated with the American Society of Clinical Rheumatology, a peer group limited to twenty members, the American College of Clinical Pharmacology and the American Society of Clinical Pharmacology and Therapeutics (Roth, Tr. 1494). Dr. Roth has been involved in clincial testing and has

published many papers on this subject in peer-reviewed journals, including the *Journal of Rheumatology, Excerpta Medica,* and the *Journal of Clinical Pharmacology.* In addition, Dr. Roth has been invited to lecture at many seminars and symposiums (Roth, Tr. 1507–11; CX 369E–O). Dr. Roth has [12] been involved in the editing of various professional journals and books and other resource works on rheumatology (Roth, Tr. 1509–11; CX 369A, P). He is extensively involved in writing and lecturing about clinical evaluations and current work relating to analgesic and anti-inflammatory agents (Roth, Tr. 1513).

20. Dr. Roth's research background and clinical experience, as well as his familiarity with the current literature qualify him well as an expert in rheumatology and in the design, execution and analysis of clinical research regarding analgesic and anti-inflammatory drugs.

D. *Ann Silny, Ph.D.*

21. Dr. Ann Silny is Vice President of Client Services for ASI Market Research, a Los Angeles firm involved in custom research, syndicated copy testing and program testing for networks (Silny, Tr. 684–85). Dr. Silny holds a Ph.D. in experimental psychology from the University of California, Berkeley, with her primary area of graduate study being in the design and conduct of experiments and the analysis of experimental results with a specialization in behavioral endocrinology (Silny, Tr. 691–92). Throughout her studies at Berkeley, she taught such courses as Introductory Psychology, Cognative Psychology, Information Processing, and Comparative Psychology (Silny, Tr. 693). During graduate school, she studied under Dr. Leo Postman, a well-known theoretician and recognized authority in the area of learning and memory (Silny, Tr. 694). After receiving her Ph.D. in 1975, Dr. Silny joined the Roosevelt University in Chicago as Assistant Professor of Psychology teaching basic courses in research and methodology and design and quantitative methods (Silny, Tr. 694).

22. In her present position at ASI, Dr. Silny, after conferring with a client to determine their research objectives, recommends a research design using either a standardized copy testing system or designing custom research. She oversees the implementation of that research and then performs data analysis and presentation recommendation to the client. Most of Dr. Silny's time is devoted to the design of custom research which is research design custom tailored to specific research objectives as opposed to standardized research which is done under the same format with the same set of measures (Silny, Tr. 686–87). Dr. Silny has performed attitudinal tracking studies, media evaluation experiments and syndicated copy testing for many major consumer research clients including Alberto-Culver, Firestone,

Arco, Chevron, Home Box Office, and [13] VISA (Silny, Tr. 688–89). In Dr. Silny's previous position with ASI, she was responsible for decisions as to appropriate statistical tests, conducting those tests and evaluation of the data. In addition, she supervised the maintenance of norm systems which are records of how commercials in given categories have tested over a period of time. This system becomes the evaluative benchmark (Silny, Tr. 689–90).

23. Dr. Silny has published in various textbooks and technical journals (Silny, Tr. 695; CX 31B). She is a member of the Advertising Research Foundation, the American Marketing Association and the Association of Consumer Research (Silny, Tr. 695). Dr. Silny has served as an expert witness in cases involving consumer research, including *Vidal Sassoon v. Bristol Myers* and *U-Haul v. Jartran* (Silny, Tr. 696).

24. Dr. Silny is a qualified expert in the design, execution and interpretation of advertising copy research.

25. Thompson called a large number of expert witnesses. Five expert witnesses testified regarding the marketing, advertising and consumer psychology issues. They are Jacqueline Silver, Dr. Ivan Ross, Dr. Roslyn Freudenthal, Dr. Kenneth M. Warwick and Jay Jasper. Ten expert witnesses testified regarding the medical/scientific issues. They are Drs. H.I. Maibach, R.L. Marlin, A.J. Patel, S.L. Altschuler, J.L. Rabinowitz, G.E. Ehrlich, E.L. Golden, W.M. O'Brien, H.I. Silverman and S.I. Heller.

E. *Howard I. Maibach, M.D.*

26. Dr. Howard I. Maibach's testimony and his qualifications as an expert in dermatology, dermatopharmacology, and the percutaneous absorption of drugs have been stipulated by counsel. Dr. Maibach is a Professor of Dermatology at the University of California Medical School, San Francisco, California. He is a Research Associate at the Cancer Research Institute, is on the active staff of the University of California - H.C. Moffitt Hospitals, and is a Consultant in Dermatology to the Stanford Research Institute and to the State of California Department of Public Health. He is a Diplomate of the American Board of Dermatology (certified in 1961), and is a Fellow of the American College of Physicians. He is a member of the American Academy of Dermatology, the New York Academy of Sciences, the American Federation for Clinical Research, the American Dermatological Association, and the American Society for Clinical Pharmacology and Therapeutics. He is on the Board of Editors of the *International Journal of Dermatology.* He [14] has published over 400 papers on dermatology, including percutaneous absorption or penetration of topical drugs.

F. *Robert L. Marlin, Ph.D.*

27. Dr. Robert L. Marlin has been a consultant in the field of clinical research since 1972. Most of his clients are pharmaceutical companies. Dr. Marlin advises pharmaceutical companies on the design of clinical studies, helps define the scope of the investigations, initiates and monitors the clinical research, and after the investigation is completed, works with the clinician to review the results (Marlin, Tr. 3150–51).

28. Dr. Marlin received a bachelor's degree in psychology from Syracuse University, a master's degree in administration from the Maxwell School in Syracuse, and a doctorate in information science from Rutgers University. His doctoral research investigated the reliability of the adverse reaction reporting system in the FDA hospital reporting programs. Dr. Marlin has also taken post-graduate courses in pharmacology at Rutgers University (Marlin, Tr. 3154–56).

29. Dr. Marlin's first professional position was with the New York State Department of Mental Hygiene as an assistant in the testing of the patient population at a State facility. His next position was with the Sterling-Winthrop Research Institute, where he later became an assistant to the executive vice president of Winthrop Laboratories. His duties included the evaluation of laboratory data, biological data, pharmacological data, and other clinical information on drugs which were being licensed in the United States or other countries in Europe or the Far East. Concurrently, Dr. Marlin worked in the clinical research department of the company, monitoring the clinical trials conducted by Winthrop Laboratories in the southeast part of the United States, including clinical trials of a parenteral analgesic, an anesthetic, and several radioactive-type drugs used as diagnostic tools. Dr. Marlin's next position was coordinator of medical affairs for Knoll Pharmaceutical. In that position, he was responsible for designing the protocols for the clinical investigations, initiating the studies, monitoring the studies, and evaluating the data and oversaw the submission of the drug to the FDA for approval. While at Knoll, Dr. Marlin supervised the research for various drugs in the analgesic and asthmatic areas. Thereafter, Dr. Marlin was employed by Schering Pharmaceutical as an assistant to the vice president of Research of New Product Development and oversaw the research for new products. Dr. Marlin also worked for Sandoz as the senior clinical research associate, where he remained for [15] six years until 1975 when he opened a consulting business. Dr. Marlin has been involved in clinical research on both ethical and OTC preparations for some twenty pharmaceutical companies. His work with OTC drugs has

involved mostly analgesics such as aspirin, acetophenetidin, and other salicylates (Marlin, Tr. 3156–63).

30. Dr. Marlin is a member of the Drug Information Association, The American Association for the Advancement of Science, The New Jersey Academy of Science, The American Statistical Association, and The Biometric Society (Marlin, Tr. 3163–66). Dr. Marlin is qualified as an expert in clinical trials for the evaluation of the safety and efficacy of drug substances.

G. *Professor Alain Jacques Patel*

31. Professor Alain Jacques Patel is a French physician and is chief surgeon and head of the orthopedic and traumatologic surgery department at the Raymond Poincare Hospital, Paris, France, a teaching hospital connected with the University of Paris, where he is a professor of medicine. The orthopedic and traumatologic surgery department with 144 beds provides both in-patient and out-patient care. The majority of patients in the department suffer from musculoskeletal problems. Professor Patel treats many patients with rheumatic disease (Patel, Tr. 1805–06, 1812). Dr. Patel divides his time among treating patients, teaching graduate and post-graduate refresher courses in medical treatment and surgery, and doing research. He conducts research at the Institute of Research in Orthopedics, connected with the University of Paris. He has been president of the Institute for approximately ten years (Patel, Tr. 1815–17).

32. About twelve years ago, the French Ministerial of Health designated Professor Patel as a national expert on drugs. In this capacity, Professor Patel conducts tests on the efficacy and safety of new drug products. In order for a drug to be put on the French market and qualify as an approved drug for Social Security purposes, it must first be tested and approved by designated experts of the French Ministerial of Health. He has conducted about twenty-four clinical tests. Because his specialty involves musculoskeletal and bone disease of which pain, swelling, and limitation of movement are the primary symptoms, many of the drugs that Professor Patel has tested have been analgesics (Patel, Tr. 1817–20). Professor Patel is also associated with the French Foreign Office as the medical coordinator for all medical affairs for [16] Southeast Asia. Until he became a designated national expert on drugs, he had published about 175 papers on such topics as orthopedic lesions, congenital or rheumatological lesions, traumatologic cases, research on trauma, and research or drugs (Patel, Tr. 1822–23, 1835–36).

33. Professor Patel has received many honors for his work in orthopedics and traumatology, including the Croix du Merite National from the French Ministerial of Health, which is regarded as the high-

est honor the French government bestows on a civilian of his age (Patel, Tr. 1836–37). Professor Patel is qualified as an expert in osteoarthritis, rheumatoid arthritis, and cases involving bone, muscle, and ligament difficulties.

H. *Stanley L. Altschuler, M.D.*

34. Dr. Stanley L. Altschuler is a physician licensed to practice in New York, New Jersey, and Pennsylvania. He is a board-certified specialist in internal medicine and pulmonary diseases. In addition to a private practice, Dr. Altschuler is on the staff of the Medical College of Pennsylvania, Frankfort Hospital, Nazareth Hospital, and the Albert Einstein Medical Center, all of Philadelphia. He has teaching responsibilities in internal medicine and pulmonary disease at Frankfort Hospital, the Medical College of Pennsylvania, and the Albert Einstein Medical Center. He also makes medical rounds with the hospital staff. Dr. Altschuler is a member of the American College of Physicians, the American Thoracic Society, and the Pennsylvania Lung Association (Altschuler, Tr. 2990–91, 2993–94, 3003).

35. Dr. Altschuler attended medical school at Upstate Medical Center in Syracuse, New York. He interned at Monmouth Medical Center in New Jersey and did his medical residency at the Veterans Administration Hospital at the Medical College of Pennsylvania, which was followed by a two year fellowship in pulmonary disease at Temple University. Thereafter, Dr. Altschuler joined the staff of the Philadelphia VA Hospital, where he remained for approximately eight years and began a private practice. In 1979, he resigned from the staff of the VA Hospital for full-time private practice. Approximately 20% of Dr. Altschuler's patients have rheumatic difficulties (Altschuler, Tr. 2990–92, 2994).

36. Dr. Altschuler has conducted some ten clinical tests on drug products for pharmaceutical companies. Generally, the agents that he has tested have been for use in the field of internal medicine. Dr. Altschuler is also the author of several [17] articles in the fields of his specialties (Altschuler, Tr. 2994, 2995–96; RX 575). Dr. Altschuler is qualified as an expert in internal medicine, pulmonary disease, and the conduct of clinical trials for the testing of drugs.

I. *Joseph L. Rabinowitz, Ph.D.*

37. Dr. Joseph L. Rabinowitz is a biochemist who specializes in the field of lipid isotopes. His work consists of using radioactive isotopes to discover how the body utilizes fat and how it metabolizes nutritional products and drugs. Many of his projects involve and analysis of drug absorption and he has been using radioactive carbon (carbon 14) in his biochemical and pharmacological research for thirty years. He

has conducted research for a number of pharmaceutical companies in the area of radioactive tracers and drug absorption testing (Rabinowitz, Tr. 3481, 3491–92).

38. Dr. Rabinowitz is currently chief of radioisotope research at the VA Hospital in Philadelphia and a professor of biochemistry at the University of Pennsylvania. His responsibilities at the University consist of teaching biochemistry and radioisotope courses to medical and dental students at the graduate level and overseeing the radioisotope research conducted at the University. As chief of radioisotope research at the VA Hospital, he functions as an advisor to investigators on the feasibility and desirability of using isotopes in their research. In addition, Dr. Rabinowitz serves as a reviewer and/or a member of the editorial boards of several professional journals, including the *Journal of Medicinal Chemistry,* the *Journal of Lipid Research,* and the *Journal of Nuclear Medicine*(Rabinowitz, Tr. 3482–83; RX 563).

39. Dr. Rabinowitz received his Master of Science degree in chemistry and his doctorate in organic chemistry from the University of Pennsylvania. He has done postdoctoral work in biochemistry, chemistry, and physiology at the University of Pennsylvania; Carlsberg Laboratory in Copenhagen, Denmark; Milstead Enzyme Laboratory in England; and Orsay Physiology Laboratory in Paris, France. With respect to radioisotope research, Dr. Rabinowitz has taken several physics and radiation safety courses at the University of Pennsylvania, has received on-the-job training in the handling and use of radioisotopes, and has taken courses in isotope technology at the College of Pharmacy at the University of Pennsylvania. He has been licensed for many years by the Atomic Energy Commission to use and possess radionuclides (radioactive atoms) (Rabinowitz, Tr. 3481–82; RX 563). [18]

40. Dr. Rabinowitz is a member of a number of professional societies, including the American Society of Biological Chemistry. Membership in this society is considered difficult to achieve. Dr. Rabinowitz has been honored for his work in radionuclides with many awards, including the Doctor Honoris Causa from the University of Bordeaux, France; the Harrison Award in Chemistry from the University of Pennsylvania; the Fulbright Professor Award in Biochemistry at the Carlsberg Laboratory, Denmark; The Silver Medal of the City of Bordeaux, France; and the Medal of the City of Nancy, France (Rabinowitz, Tr. 3484–85; RX 563). Dr. Rabinowitz has published some 200 books, articles, and abstracts, including many that discuss radioactive materials and their interrelationships with drugs. He has co-authored a book on radioisotope methodology which is used in many universities throughout the world (Rabinowitz, Tr. 3490–92).

Dr. Rabinowitz is well qualified to give testimony as an expert in radioisotope testing.

J. *George E. Ehrlich, M.D.*

41. Dr. George E. Ehrlich is currently a professor of medicine and director of the Division of Rheumatology of Hahnemann Medical College, Philadelphia, Pennsylvania and specializes in rheumatology. At Hahnemann, he provides a teaching program for medical students, health professionals, and graduate physicians specializing in rheumatology, provides patient care programs in rheumatology and helps guide research in rheumatology (Ehrlich, Tr. 3980–82). He is also on the associate staff of Albert Einstein Medical Center and the Moss Rehabilitation Hospital (Ehrlich, Tr. 3980–82).

42. Dr. Ehrlich received his undergraduate degree from Harvard University and his bachelor of medicine and doctor of medicine degrees from Chicago Medical School. He did his internship at Michael Reese Hospital in Chicago. He followed his internship with several residencies: Francis Delafield Hospital of Columbia Presbyterian Medical Center, New York City (soft tissue pathology and surgery); Beth Israel Hospital, Boston (internal medicine); and Tufts New England Medical Center, Boston (senior residency in medicine). After his residencies, Dr. Ehrlich did two fellowships in rheumatology, the first at the National Institute of Arthritis and Metabolic Diseases of the National Institute of Health, and the second at a hospital for special surgery at the New York Hospital Medical Center Complex of Cornell University. Concurrently with this second fellowship, he held a special fellowship in research at the Sloan-Kettering Institute. Prior to joining the faculty at [19] Hahnemann College, Dr. Ehrlich was a professor of medicine and rehabilitative medicine at Temple University School of Medicine and director of the Section of Rheumatology at the Albert Einstein Medical Center and Moss Rehabilitation Hospital (Ehrlich, Tr. 3980–82).

43. Many awards and honors granted to Dr. Ehrlich for his work in rheumatology include the distinguished alumnus award from Chicago Medical School, the Phillip Hench award of the Association of Military Surgeons, several Distinguished Service Awards from the Arthritis Foundation, two official citations from the City of Philadelphia, The Order of the Star with the rank of Cavaliere from the Italian Solidarity, the Phillip Hench lectureship from the American College of Physicians (twice), and the William K. Ishmael lectureship at the University of Oklahoma (Ehrlich, Tr. 3982–84).

44. Dr. Ehrlich is a former consultant on inflammatory drugs to the FDA Bureau of Drugs. He is currently a consultant to the American Medical Association Directory of Drugs, and serves as a consultant to

pharmaceutical companies on the development of testing for new inflammatory drugs. He is a member of numerous professional organizations and holds fellowships in various organizations including the American College of Clinical Pharmacology, the American Congress of Rehabilitation Medicine, and the American College of Physicians (Ehrlich, Tr. 3985–87; RX 135). Dr. Ehrlich's publications on rheumatology numbering some 150, includes papers concerned with the clinical testing of drugs, as Dr. Ehrlich has participated in more than thirty clinical trials in the past twenty years (Ehrlich, Tr. 3987–88).

45. Dr. Ehrlich has testified at many proceedings as an expert. He was invited by the Food and Drug Administration to give testimony as to the value of studies that were submitted as efficacy evidence for salicylate drugs and related inflammatory drugs. He has also testified at the Department of Health, Education and Welfare regarding the federal licensing program for physical therapists. He has been an expert witness in a variety of litigation involving malpractice cases and compensation cases (Ehrlich, Tr. 3989–90). Dr. Ehrlich is qualified as an expert in the design, execution, and analysis of clinical trials and is well qualified as an expert in rheumatology (Ehrlich, Tr. 3990–91).

K. *Emanuel L. Golden, M.D.*

46. Dr. Emanuel L. Golden is a specialist in internal medicine and rheumatology. He has practiced in internal [20] medicine since 1956 and in rheumatology since 1960. His current practice is approximately 75% rheumatology and 25% internal medicine, and he sees between 100 and 125 patients a week. He is certified as a Diplomate of the American Board of Rheumatology, and as a Fellow of the American College of Physicians. He is affiliated with the North Broward Hospital and the Boca Raton Community Hospital in Florida. Dr. Golden is a member of the American Rheumatism Association, the Arthritis Foundation, the Broward County Arthritis Foundation, and the American Medical Association. He is an accredited lecturer in rheumatology for the Palm Beach Arthritis Foundation and the Broward County Arthritis Foundation, and he lectures at the hospital staff training programs for nurses and therapists at North Broward Hospital and Boca Raton Community Hospital. Dr. Golden is also a visiting physician at the Jackson Memorial Hospital at the University of Miami (Golden, Tr. 2647–49, 2663–68; CX 327).

47. Dr. Golden received his medical training at the Chicago Medical School, interned at Brooklyn Jewish Hospital, and did a three year medical residency at Kingsbridge Veterans Hospital in New York City. Prior to attending medical school, Dr. Golden received one year

of post-graduate training in bio-chemistry and endocrinology. From 1960 to 1963, Dr. Golden trained with Dr. Steinbrocher at the Joint Disease Hospital in New York City, where he received further training in joint diseases from a clinic which was run by the school. After spending three years at the Joint Disease Hospital, Dr. Golden was appointed by the director of medicine at Mt. Sinai Hospital to the position of director of the arthritis clinic at Greenpoint Hospital, a city hospital which was at that time affiliated with Mt. Sinai Hospital. From here, he moved to Elmhurst City Hospital, a teaching hospital affiliated with Mt. Siani, and became an associate professor of medicine at Mt. Sinai Hospital School of Medicine. He stayed at Elmhurt City Hospital for ten years during which time he taught interns and residents in the field of rheumatology, acted as a consultant to the hospital, and directed both the Regular Arthritis Clinic and the Combined Arthritis Rehabilitation Clinic. As director of the Regular Arthritis Clinic, Dr. Golden set up a treatment program for outpatients with arthritis, ran the clinic, and supervised a staff of three rheumatologists. Approximately 100 patients a week were treated on a regular basis at this clinic. The Combined Arthritis Rehabilitation Clinic was created by Dr. Golden in collaboration with a doctor in rehabilitative medicine. The object of this clinic was to tailor a treatment program for chronic arthritics to meet all of their medical needs. This combined treatment clinic was a new concept at this time, but has since been adopted by other hospitals. Dr. Golden [21] served as the director of the Combined Clinic and oversaw the activities of the entire staff of physicians, residents, therapists, and paramedics (Golden, Tr. 2648–61). In 1975, when the American College of Physicians formally recognized rheumatology as a special field of medicine, Dr. Golden took the required examination and became a Diplomate of the American Board of Rheumatology (Golden, Tr. 2649). Dr. Golden is well qualified as an expert in internal medicine and rheumatology.

L. *William M. O'Brien, M.D.*

48. Dr. William M. O'Brien is a physician and a specialist in rheumatic diseases. Dr. O'Brien is an attending physician at the University of Virginia Hospital and Blue Ridge Sanitarium and a professor of internal medicine at the University of Virginia Medical School. In his capacity as a professor, he runs four clinics a week, one for patients with rheumatoid arthritis, two for patients with general rheumatic disease, and one for patients with lupus erythematosus (O'Brien, Tr. 3642–43).

49. After graduating from Yale Medical School, Dr. O'Brien trained in internal medicine at Massachusetts General Hospital and at Harvard. He did a Fellowship at the National Institute of Arthritic and

Metabolic Diseases at the National Institute of Health. At the Manchester Royal Infirmary in England, he served as Senior Registrar in rheumatology. For three years, he was Senior Clinical Investigator at the Arthritis Institute of the National Institute of Health. He was an assistant professor in internal medicine for three years at Yale Medical School. He has held his present position as a professor of medicine at the University of Virginia for eleven years (O'Brien, Tr. 3642).

50. Dr. O'Brien has been accorded many honors for his work. He is a member of the Heberden Society in England, a society limited to 100 experts in rheumatology. He is a member of the Academy of Medicine in Chile, and has received an award from the American Epidemiology Society. As an adviser to the chief of medicine of the Veterans Administration, he served for four years on the committee that designs the long-term clinical trials for the Veterans Administration. The many clinical trials Dr. O'Brien was involved in included the trials to discover the role of aspirin in preventing myocardial infarction. He also served as medical consultant to the Consumers Union of the United States for three years and has assisted for many years in the publishing of a medical letter on clinical trials established by the Consumers Union. Recently, he published two letters criticizing the use of the arthritis prescription drugs Oraflex and Feldine (O'Brien, Tr. 3643–44). [22] The professional societies to which Dr. O'Brien belongs include the American Rheumatism Association and the Anti-Inflammatory Drug Study Group. In his association with the former he designed and directed, for six years, all of the clinical trials run by the association. These trials, through the association's cooperating clinic committee of which Dr. O'Brien was chairman, focused on anti-rheumatic drugs. This year he was made co-president of the Anti-Inflammatory Study Group which provides for discussion among physicians about clinical trials (O'Brien, Tr. 3644–45).

51. Dr. O'Brien has published numerous articles, books, and lectures. Most of these are in the field of rheumatology and most concern the testing of drugs. While he was chairman of the cooperating clinic committee of the American Rheumatism Association, Dr. O'Brien published in the *New England Journal of Medicine* and in *Clinical Pharmacology and Therapeutics* a series of articles on trials which he conducted on aspirin and aspirin-like drugs (O'Brien, Tr. 3645–46). He has appeared before the Federal Trade Commission, the FDA Internal Analgesic Advisory Panel, and the United States Senate. Many drug companies have requested him to render opinions on analgesics and anti-inflammatory drugs (O'Brien, Tr. 3646–48). Dr. O'Brien is well qualifed as an expert in rheumatology; internal medicine; and the design, execution, and analysis of clinical trials.

M. *Harold I. Silverman, Ph.D.*

52. Dr. Harold I. Silverman is a professor of pharmacy and executive director of Pfeiffer Pharmaceutical Sciences Laboratories at the Massachusetts College of Pharmacy and Allied Health Sciences, Boston, Massachusetts. He is also a member of the faculty at Boston University Medical School and the New England College of Optometry. He is a registered pharmacist in Massachusetts, New Jersey, and Pennsylvania. Dr. Silverman has been the executive director of Pfeiffer Pharmaceutical Sciences Laboratories since its inception approximately five years ago. In this role, Dr. Silverman helps plan, design, and execute the research at the laboratory and is responsible for all the reports it issues. The staff also provides teaching for Massachusetts College of Pharmacy and Allied Health Sciences of which the laboratory is a part. Dr. Silverman has taught courses in biopharmaceutics (the development, design, and analysis of a pharmaceutical product), product development, industrial pharmacy, physical pharmacy, and OTC drug products. All of these courses have touched upon FDA rules and regulations and the toxicology, safety, and efficacy of drug substances (Silverman, Tr. 2070–76, 2086–89, 2090–92). **[23]**

53. Dr. Silverman began his education as a pharmacist at the Philadelphia College of Pharmacy and Science, graduating with a baccalaureat degree in 1951, a masters degree in 1952, and a doctorate in 1956. Thereafter, he went to Long Island University as a professor of pharmacy and taught basic pharmaceutics, veterinary pharmacy, physical pharmacy, and dosage form development. During part of this time, he also worked as a senior scientist at Warner Lambert Research Institute. Following his teaching at Long Island University, Dr. Silverman worked for Knoll Pharmaceutical Company for several years, attaining the position of vice president in charge of pharmaceutical research and development. He left Knoll Pharmaceutical to begin work at the Massachusetts College of Pharmacy as a professor of pharmacy and chairman of the Department of Pharmacy. After a time, he became the associate dean and executive director of the Pfeiffer Pharmaceutical Sciences Laboratories. Throughout most of his career, he has remained in touch with the practical side of his field by working part-time as a registered pharmacist (Silverman, Tr. 2076–77, 2079, 2092).

54. In addition to belonging to numerous societies, holding various appointments as a lecturer or visiting scientist, serving as an advisor to the Food and Drug Administration, and having been honored with many awards including the Newcomb Award for original research in pharmacognosy, Dr. Silverman is the author of numerous publications. At the present time, his major areas of interest are the develop-

ment of drugs, the evaluation of the dosage form, and improvement of the bioavailability of drugs. Dr. Silverman has studied topically creams and barriers, and the absorption of chemical substances through the skin (Silverman, Tr. 2099–101; RX 573). Dr. Silverman is qualified as an expert in pharmacy, pharmacokinetics, drug absorption, drug stability, bioavailability, and the safety, efficacy, and mode of action of topical and oral drugs as seen from the perspective of a pharmaceutical expert.

N. *Saul I. Heller, M.D.*

55. Dr. Saul I. Heller is a physician licensed to practice medicine in New York and Connecticut and specializes in psychiatry, neurology, and acupuncture and is certified as a Diplomate of the American Board of Psychiatry and Neurology. Throughout his years of practice, Dr. Heller has been interested in the treatment of pain. He received the first license in New York State for the practice of acupuncture, and was instrumental in developing the legislation which established the [24] acupuncture licensing program. Dr. Heller has been engaged in private practice for fifty years. In his practice, he has treated over 25,000 patients for pain-related problems and disorders. The most common disorder that he sees in his patients is headache pain of various types, but he also sees patients with spinal symptoms, neuralgia, bursitis, and tendonitis. As most of his patients suffer from arthritis from time to time, it is not uncommon for him to treat arthritis-related pain (Heller, Tr. 2565–66, 2571–72, 2579–81).

56. Dr. Heller received his Bachelor of Arts degree from Cornell University and His Doctorate of Medicine from Cornell Medical College. Following his graduation, Dr. Heller interned at Lenox Hill Hospital and did his residency at the New York State Psychiatric Institute, a division of Columbia Presbyterian Medical Center. He thereafter served as a research fellow at Bellevue Hospital in New York. Throughout his practice, Dr. Heller has served on the attending staff of several major New York hospitals, including Bellevue Hospital, New York University College of Medicine, Riverside Hospital, LeRoy Hospital, Gracie Square Hospital, Mid-Island Hospital, and Nassau County Medical Center. For five years, he was a member of the faculty of New York University College of Medicine and taught courses in psychiatry. He served for ten years as the director of the Neurology and Psychiatry Departments at Cabrini Hospital (Heller, Tr. 2566–67).

57. Dr. Heller has held many government appointments, including that of medical advisor to the director of the Selective Service System. He was president of the New York State Board of Medicine and president and founder of the New York Society of Acupuncture for

Physicians and Dentists. He has served on the Insurance Committee of the American Psychiatric Association, the Medical Malpractice Panel of the New York State Supreme Court, and the Medical Grievance Committee of the New York State Board of Regents. Dr. Heller was appointed to the Rockefeller Commission to study the uses, efficacy, and regulations of acupuncture. He has been vice president and trustee of both the American College of Acupuncture and the International College of Acupuncture (Heller, Tr. 2469–70). Dr. Heller is the author of two publications that discuss his studies on the use of Sedac electrical current in acupuncture to relieve pain. He has received many honors for his professional work including a Congressional Medal of Honor (Heller, Tr. 2572–74; 2578–79). Dr. Heller is qualified as a specialist in neurology, psychiatry, and the diagnosis and treatment of pain-related problems. [25]

O. *Roslyn Freudenthal, Ph.D.*

58. Dr. Roslyn Freudenthal is a statistical consultant specializing in biomedical trials and psychological research. She received her bachelor of science degree in chemistry with minors in mathematics and physics from New York University in 1931. In 1933, she obtained a master's degree in microanalysis, and in 1940, a doctorate in organic synthesis with a minor in biochemistry, both from New York University. Her studies were supplemented by a year at Pregl Institute at the University of Graz, Austria where she studied microanalysis, and by a year at Fordham University, where she took a graduate course in statistical applications in experimental science.

59. Dr. Freudenthal began her career as a research chemist in 1937, but taught herself statistics by reading recognized works on the subject. Realizing the extent of the demand for biostatisticians, she decided to go into the field. In 1940, she left the Psychiatric Institute to work at Killian Research Laboratory in New York City. Although hired as a chemist, she continued to do statistical work, analyzing the results of the studies conducted at the laboratory. After three years, she went to the Food Research Laboratory in Long Island City as a biometrist and the director of research and became a full-time statistician. Dr. Freudenthal designed and interpreted bioassays and acted as a statistical consultant for clients. In 1947, Dr. Freudenthal left the Food Research Laboratory and became a private consultant (Freudenthal, Tr. 4869–74; RX 88).

60. Over the years, Dr. Freudenthal has performed consulting work for many physicians in connection with their clinical research. She has also worked for Thompson Medical Company for over twenty years and has been involved with approximately thirty projects. In the past thirty to forty years, Dr. Freudenthal has participated in

approximately 300 research projects and clinical trials and approximately 125 clinical trials. On these 125 trials, roughly twenty have involved analgesic medications such as Aspercreme, aspirin, sodium salicylate, and methyl salicylate (Freudenthal, Tr. 4878–90; RX 88). Dr. Freudenthal has contributed to many published papers, and her name appears on about twenty of them. She is a member of Phi Beta Kappa, the New York Academy of Sciences, the American Statistical Association, Sigma Xi, and the Biometric Association (Freudenthal, Tr. 4891–92; RX 88). Dr. Freudenthal is qualified as an expert in the evaluation of medical research data and the setting up of codes for clinical trials.

61. Respondents called the following advertising and consumer research experts. [26]

A. *Jacqueline Silver*

62. Ms. Jacqueline Silver is a senior vice president of Needham Harper & Steers ("NH&S"), a major international advertising agency ranked among the top twenty advertising agencies in the world (Silver, Tr. 5583). Her responsibilities include the Research Department of NH&S's New York office (Silver, Tr. 5584), the chairing of the important Strategy Review Board and the Advertising Review Board of NH&S (Silver, Tr. 5584–85). The Strategy Review Board reviews research strategies developed for its advertising compaigns (Silver, Tr. 5586–87). The Advertising Review Board reviews the advertising plans developed by the account groups and the advertising created in accordance with the strategies approved by the Strategy Review Board (Silver, Tr. 5587–88). Ms. Silver's duties also include the design, implementation and analysis of research programs developed for NH&S clients (Silver, Tr. 5588–89). She is directly responsible for all research, including studying the marketplace, positioning the product within the competition, assessing the attitudes of consumers, establishing the product's primary benefits and profiling the consumer in terms of psychographic dimensions (Silver, Tr. 5588–89). The agency regularly conducts strategic studies, copy tests, tracking studies and product tests which Ms. Silver oversees (Silver, Tr. 5592–93). NH&S also conducts the "Lifestyle Study,, on an ongoing basis as a current source of information with respect to consumer behavior and attitudes (Silver, Tr. 5626–27). Prior to joining NH&S in 1976 as Director of Research, Ms. Silver was vice president-executive research director at Grey Advertising, Inc. where she conducted research for clients, including drug companies such as Sandoz, Bristol-Myers, Richardson, Merrill, A.H. Robbins, Sterling Drug, Whitehall Laboratories, and Merck, Sharpe & Dome (Silver, Tr. 5602). Ms. Silver has also assisted clients in the development of product packaging and

labeling, the creation of brand names and their positioning within the product category (Silver, Tr. 5602–03). She has conducted approximately fifty studies with respect to brand names and approximately 200 studies on product packaging (Silver, Tr. 5603) and has been involved in some ten strategic studies of analgesic products, including a research project for internal analgesics for arthritis (Silver, Tr. 5606–07). Recently, Ms. Silver conducted a study for the USDA on nutrition in which her role included the design, execution and presentation of the research (Silver, Tr. 5608).

63. Ms. Silver has an Associate of Arts Degree from the University of California at Berkley and a Bachelor of Science in [27] Mathematics from New York University. Ms. Silver has since taken courses in experimental design, statistics, computer sciences and psychology at New York University and The New School. After beginning her career as an interviewer at age fifteen, she has been employed by many market research organizations including Opinion Research Corporation, Market Facts, National Analysts, Mervin Fields, Human Factors, Marketing Impact, Oxtoby Smith, and Daniel Starch (Silver, Tr. 5611-12). At Marketing Impact and Oxtoby Smith, (research suppliers), she was a field director (Silver, Tr. 5613), at Data Decision, a computer company, a group head in charge of processing and analyzing copy tests for Colgate-Palmolive, among other client companies (Silver, Tr. 5613–14) and at Market Facts, Inc., senior study director (Silver, Tr. 5614).

64. Ms. Silver regularly reads the important journals which focus on advertising, market research and consumer behavior (Silver, Tr. 5631). Ms. Silver is a member of the American Marketing Association, Advertising Women of New York, the Advertising Research Foundation (being a member of the latter's Copytesting Practices Committee and the Public Opinion Committee), the American Association of Advertising Agencies (Silver, Tr. 5627) and the Association of Advertising Research Directors. Ms. Silver has given courses, seminars and presentations in marketing research, strategy development and techniques (Silver, Tr. 5629). Ms. Silver has a broad range of practical experience in the design, execution and analysis of consumer and market research (Silver, Tr. 5620). Ms. Silver is qualified as an expert in market and consumer research, advertising strategy and evaluation, including packaging and brand names, consumer behavior, and the design, implementation and analysis of market and advertising research.

B. *Ivan Ross, Ph.D.*

65. Dr. Ivan Ross is a Professor of Marketing at the University of Minnesota School of Management and former Chairman of the Mar-

keting Department. He is a member of the Graduate Faculty of the College of Business Administration and the Department of Psychology of the University (RX 570). Dr. Ross has a doctorate in Industrial and Consumer Psychology and teaches courses in Consumer Behavior, Advertising and Sales Promotion, Marketing Research and Marketing Communications (RX 570). Dr. Ross is a licensed Consulting Psychologist. His areas of specialization include consumer behavior, marketing and advertising research, motivation research, and the design and analysis of consumer and marketing surveys and experiments, including the construction of questionnaires (RX 570). [28]

66. Dr. Ross has published many papers on consumer psychology and attitudes, marketing analysis and research and the selection and meaning of brand names (RX 570F–I) and has spoken before professional associations and societies dealing with consumer behavior and decisionmaking (RX 570). Dr. Ross has been a consultant to the United States Public Health Service and to the FDA Bureau of Drugs from 1976 to 1977 with respect to package inserts and consumer information to be placed on OTC and prescription products (Ross, Tr. 5947, 5949–50). He has served as a consultant to advertising agencies with respect to advertising strategy, marketing, advertising and consumer research matters and has conducted many focus group interviews (RX 570).

67. Since 1974, Dr. Ross has been a member of the Minnesota Advertising Review Board, acting as an arbitrator of advertising complaints (Ross, Tr. 5947–48), the American Council for Consumer Interest and the Society of Consumer Affairs Professionals ("SOCAP,,) and a member and former President of the Division of Consumer Psychology of the American Psychological Association (Ross, Tr. 5948–49). He is an advisor to the State of Minnesota Office of Consumer Services with respect to consumer legislation and consumer protection issues (Ross, Tr. 5949) and has served as Vice Chairman of the Minnesota Advertising Review Board.

68. Dr. Ross has appeared in behalf of the Federal Trade Commission in administrative hearings as an expert in consumer psychology, consumer behavior and marketing research and gave testimony regarding various marketing and advertising issues, including the meaning of advertisements, the consumer perceptions of the messages in advertisements and their impact on the consumer (Ross, Tr. 5053–54). Such cases include the Federal Trade Commission's recent internal analgesic cases (*In the Matter of American Home Products Corporation,* Docket No. 8918 [98 F.T.C. 136 (1981)], *aff'd in part and mod. in part,* 695 F. 2d 681 (3rd Cir. 1982 [101 F.T.C. 698 (1983)]; *In the Matter of Bristol-Myers Company,* Docket No. 8917 [102 F.T.C. 21 (1983)]; and *In the Matter of Sterling Drug, Inc.,* Docket No. 8919 [102

F.T.C. 395 (1983)]. He has also testified as an expert in trademark infringement litigations and has served as a consultant in many trademark cases (Ross, Tr. 5962; RX 570). Dr. Ross is qualified as an expert in consumer psychology and consumer behavior, marketing research, and evaluation of advertising and trademarks.

C. *Dr. Kenneth M. Warwick*

69. Dr. Kenneth M. Warwick is the President of Ken Warwick & Associates, Inc. (a marketing research consulting firm) and [29] has been in the marketing research business for over twenty years. He graduated from Queens University in Ireland with a Bachelor of Arts degree in Psychology. In 1963, Dr. Warwick received a Doctorate in Psychology and Statistics from the University of London. He has taught courses in Experimental Psychology, Consumer Psychology, Research Design, Methodology and Analysis, and Statistics at London University, Northwest University, Columbia University and New York University. He has been a reviewer of faculty research proposals for the City University of the City of New York for the past five years. In the United Kingdom, he was a partner in an advertising research firm, DRC, Limited. In this country, Dr. Warwick has served as a consultant in marketing and consumer research to two advertising agencies, Foote, Cone & Belding and Kenyon & Eckhardt. He was employed as Executive Vice President of Grudin, Appel & Haley, a market research company (which performed marketing and advertising research for such companies as Warner-Lambert, ITT, American Cyanamid and the Lorillard Corporation) and supervised the Statistical Analysis Group and the researchers and project directors engaged in the ongoing research projects and assisted in designing the execution and the analysis of market research (Warwick, Tr. 5281–82). Dr. Warwick was also employed at Grey Advertising, Inc. as a Vice President and Associate Research Director in charge of research projects for such clients as Ford Motor Company, United States Steel and General Electric (Warwick, Tr. 5280–81). In his own company, Dr. Warwick provides consulting services with respect to advertising and market research, including the design, execution and evaluation of research projects, His clients include AT&T, RCA, American Cyanamid, Warner-Lambert, and major advertising agencies such as BBD&O, Backer & Spielvogel, Scali, McCabe & Sloves, and McCann Erickson. He also provides consulting advice to law firms and market research companies and suppliers such as Simmons Market Research and Data Developing Corporation. Dr. Warwick has been involved in some 200 copy test and sixty research studies (Warwick, Tr. 5291).

70. Dr. Warwick has testified in trademark litigations and litigations involving deceptive advertising as an expert on advertising and

marketing research (Warwick, Tr. 5279–80). Dr. Warwick has published and presented numerous papers dealing with marketing research and consumer research. Among his publications is the "Statistical Data Processing in Market Research" chapter in the *Standard Handbook in Marketing Research* published by the American Marketing Association (Warwick, Tr. 5288–89; RX 577).

71. Dr. Warwick is a member of the American Psychological Association, American Statistical Association, American [30] Marketing Association, the New York Academy of Science and the Royal Statistical Society (Warwick, Tr. 5291), and is the Computer Science Editor and a member of the editorial review board of the *Journal of Marketing Research* (Warwick, Tr. 5290). Dr. Warwick is qualified as an expert in consumer psychology and the design, implementation, review and evaluation of marketing and advertising research (RX 577).

D. *Jay Jasper*

72. Mr. Jay Jasper is a Senior Vice President and Creative Director of Ogilvy and Mather International, Inc. where he has been employed for fourteen years (Jasper, Tr. 4698). As Creative Director, Mr. Jasper is responsible for supervision of the writers, art directors and producers who create advertising (Jasper, Tr. 4698–700). After graduating magna cum laude from Brandeis University, Mr. Jasper attended Yale University, the College de France and the Sorbonne (on a Fulbright Scholarship) (Jasper, Tr. 4703). He frequently lectures on advertising to advertising and trade groups as well as to management personnel of O&M throughout the world (Jasper, Tr. 4703–04). Mr. Jasper is an expert in the creation and evaluation of advertising and advertising strategy.

III. THE MARKETING AND ADVERTISING OF ASPERCREME

73. Thompson first began to market Aspercreme in 1976 after purchasing it from the Sperti Drug Company (CX 45E (Admission No. 79)). Prior to acquisition of Aspercreme by Thompson, Sperti advertised the product on a live, local television program in Ohio and part of Indiana. Thompson continued this advertising until August of 1979 (RX 285B). Spot market television advertising was first disseminated in October of 1978. Aspercreme advertising was first aired on network television in September of 1979 (RX 285C). Network, spot and syndicated television advertising for the period 1978 through 1981 included the following:

CX 1, disseminated 2,814 times from October 1978 through February 1980.

CX 2, disseminated 1,443 times from April through December 1979.

CX 3, disseminated 1,890 times from January through June 1980. [31]

CX 4, disseminated one time in December of 1979.

CX 5, disseminated 492 times in April to June 1980.

CX 9 and 21, disseminated 130 times from November 1980 through April 1981 on a combined basis.

CX 12 through 20, disseminated 253 times during the 1976 through 1979 time frame on a combined basis (CX 25).

Print advertising for the period 1978 through 1981 including the following:

CX 6 was disseminated twice in the *Readers Digest* in March and April of 1979 and once in the *Saturday Evening Post* in May of 1979 (CX 25).

CX 7, 8, 10 and 11 are co-op advertisements for which there are no specific dissemination data available: however, they were disseminated (Tr. 47–49; Paragraph 9 and Exhibits G and H of the Complaint and Paragraph 9 of the Answer).

74. For the years 1976 through 1981, Thompson's net annual sales, net sales of Aspercreme and Aspercreme advertising expenditures were as follows:

	Annual Sales	Aspercreme Sales	Aspercreme Ad Expenditures
	(000)	(000)	(000)
1976	$18,385	$ 68	$ 1
1977	29,092	289	10
1978	27,243	589	95
1979	45,847	3,188	1,768
1980	92,275	5,860	2,230
1981	N.A.	5,931	1,595
1982 (Thru July)	N.A.	4,452	2,056

(CX 45E–F (Admission No. 80); RX 573) [32]

75. From 1976 through 1981, annual consumer sales of Aspercreme averaged about $2.5 million. In promoting Aspercreme by advertising from 1976 through 1981, Thompson spent at least $5 million. Thus, annual advertising expenditures for Aspercreme from 1976 through 1981 have averaged approximately $950,000. The average advertising-to-sales ratio for Aspercreme for the 1976 through 1981 period was about 36%.

76. For the years 1976 through 1981, the share of the topical analgesic market accounted for by Aspercreme was as follows:

1976	.8%	(CX 45Z-017)
1977	.8%	(CX 45Z-017)
1978	1.4%	(CX 45Z-017)
1979	7.4%	(CX 45Z-017)
1980	16.8%	(RX 286D)

During the same time period, the market share held by Ben-Gay has remained at about 40% and that of Mentholatum, at about 9%. The market share held by Aspercreme has grown steadily from virtually nothing to 7.4% in 1979 and to 16.8% in 1980 (RX 286D).

IV. MEANING OF ASPERCREME ADVERTISEMENTS AND THE BRAND NAME "ASPERCREME"

A. *Standards For The Determination Of The Meaning Of Advertisements*

77. In determining whether an advertisement made a particular representation, the appropriate standard is whether, taking the advertisement as a whole, the representation constitutes a reasonable interpretation of that advertisement. The question is whether the representation at issue is an interpretation of the advertisement to which more than an insubstantial number of consumers would adhere. Since more often than not several reasonable interpretations of a given advertisement are possible (Ross, Tr. 5969-70), it is not necessary that the claim found to have been made be the only or the most reasonable interpretation of the advertisement.

78. The primary evidence with respect to the meaning of the advertisements in the record consists of the advertisements [33] themselves. The record also contains extrinsic or secondary evidence regarding the meaning of the advertisements, namely, expert testimony, consumer research, and evidence of how the networks and other expert bodies interpreted the advertisements.

79. In determining the meaning of individual advertisements, I have primarily relied on my knowledge and experience to determine what impression or impressions an advertisement as a whole is reasonably likely to convey to a consumer. When my initial determination is confirmed by the expert testimony of complaint counsel or respondent, I rested. When my initial determination disagreed with that of expert testimony, which was often conflicting, I reexamined the advertisement in question, and further considered other record evidence such as copy tests and other consumer research before reaching a final determination. I have not relied on such extrinsic evidence when, after careful study and reflection, I found it to be unpersuasive and contrary to the weight of evidence.

B. *Respondent Has Made Certain Representations Alleged In The Complaint*

(1) *Complaint Paragraph 10 (a)*: The claim that Aspercreme contains aspirin.

80. Thompson has respresented, expressly or impliedly, that Aspercreme contains aspirin. This representation was made in varying degrees in all of the TV and print advertisements in evidence in this proceeding. They include CXs 1-22 and 37.

81. For example, CXs 1 and 2, the earlier TV ads in evidence, unmistakably suggested that Aspercreme is an aspirin rub, which enables a user to put the relief of aspirin directly at the point of pain. CX 1, a TV commercial aired some 2,814 times from October 1978 through February 1980 (CX 25A), states in part:

> When you suffer from arthritis, imagine being able to put the strong relief of aspirin right where you hurt most.
>
> Now with amazing Aspercreme, you can get the strong relief of aspirin directly at the point of minor arthritis pain. [34]
>
> The strong relief of aspirin right where you hurt (both voice and video super).

CX 2, another TV commercial, aired some 1,400 times during 1979 (CX 25A), states in part:

> When you suffer from arthritis, imagine putting the strong relief of aspirin right where you hurt.
>
> Aspercreme is an odorless rub which concentrates the relief of aspirin.
>
> When you take regular aspirin, it goes throughout your body like this. (Video shows how regular aspirin tablets dissolve in the stomach, are absorbed in the blood and circulate throughout the body to reach the pain site in the left shoulder.)
>
> But, in seconds, Aspercreme starts concentrating all the . . . relief of two aspirin directly at the point of minor arthritis pain. (Video shows Aspercreme "concentrating all the temporary relief of two aspirin directly at the point of . . . pain" in the shoulder without going through the stomach and throughout other parts of the same body).

82. CX 9, a TV commercial which was aired in 1980 and 1981 (CX 25A), is an example of Aspercreme ads which do not contain "no-aspirin" video super or other aspirin disclaimer statements but state instead that "Aspercreme contains salycin, a strong non-aspirin pain reliever which penetrates right to the point of pain." CX 9 contains no other references to "aspirin." CX 9 is of some importance for the reason that it was copy tested by the parties separately for use in this litigation (CX 26, the ASI Theatre Test; CX 35/RX 520, the FRC Test; and CX 32/RX 500, the Lieberman Test) and was the subject of exten-

sive discussion by marketing expert witnesses of both parties at the trial.

83. Most of the more recent TV commercials for Aspercreme in evidence contain a short video super "contains no aspirin" (CX 3), or "relief without aspirin" (CX 4), or a phrase " aspirin [35] free" (CX 5). Several others contain, a statement "Aspercreme contains salycin, a strong non-aspirin pain reliever" without a "no-aspirin" video super of any type (CXs 9, 21–22). Still others contain a statement "it delivers an aspirin-like formula right in the lotion" (CX 19).

84. Several Aspercreme advertisements include affirmative statements to the effect that Aspercreme does not contain aspirin (*See* CXs 3–5, 9, 21–22, 37). These disclosure statements were added because the networks required them (Jasper, TR. 4739, 4746), and this fact indicates that the Aspercreme ads were construed as communicating an aspirin content message. Moreover, the disclosures in these particular advertisements were shown to be ineffective. With respect to CX 3 and CX 4, the "video super" is too brief in duration and disclosures obscure when compared to the repeated audio and video phrases such as "the relief of aspirin" (Cohen, Tr. 213–15; Ross, Tr. 6194). This conclusion is confirmed by CBS and the National Association of Broadcasters ("NAB"), both of which advised Thompson that a video super was insufficient to counter the net impression of these ads (See CXs 79–80, 88D). In fact, Thompson's own advertising agency had reached the same conclusion regarding the ineffectiveness of the video super (*See* CX 66B). The disclosure in the other advertisements were shown to be insufficient to overcome the aspirin content message conveyed by the brand name and the comparison to oral aspirin (Cohen, Tr. 218–22, 226–27; *see* CX 27). Moreover, some of these ads (*i.e.,* CXs 9, 21–22, 37) state that Aspercreme "contains salycin, a non-aspirin pain reliever." This phrase is ambiguous because it does not negate the impression that "Aspercreme" may also contain aspirin in addition to "salycin" (Ross, Tr. 6205–06; Silver, Tr. 5715, CX 92A).

85. In addition to the use of brand name "Aspercreme," most of the advertisements contain statements which may lead the consumer to conclude that Aspercreme is an aspirin rub. For example, a majority of the ads compare and contrast Aspercreme with pills (*i.e.,* aspirin tablets) (CXs 1–11, 21–22, 37). This direct comparison tends to lead consumers to conclude that Aspercreme contains aspirin and that Aspercreme is another form in which aspirin can be taken, that is, in cream form as opposed to pill form (Cohen, Tr. 558; Ross, Tr. 5985–87, 5988–89, 5991).

86. Another way in which the ads suggest that Aspercreme contains aspirin is to repeat the words "Aspercreme" and "aspirin" in the same

commercial (Cohen, Tr. 207). *See, e.g.,* CXs 1–4, 6–8). The two things viewers are likely to recall most from such ads are the name Aspercreme and the word "aspirin" (*Id.*). [36]

87. Many of the Aspercreme advertisements in evidence state more than once that Aspercreme provides "the strong relief of aspirin" (*See, e.g.,* CXs 1–4, 6–7, 10–11). In the print ads (CXs 6–7, 10–11), this statement appears in the subheadline, which is more prominent than the test (Cohen, Tr. 223; Ross, Tr. 6199). The phrase "relief of aspirin" is, of course, provided by aspirin (Ross, Tr. 6179–80). Indeed, Mr. Jasper indicated that, in creating ad copy, he would consider the phrase "aspirin's relief" to be an excellent way of communicating aspirin content (*See* Jasper, Tr. 4738). Even if "relief of aspirin" is understood to mean the relief of tablets containing aspirin (*See* Ross, Tr. 6181–82), the fact remains that the relief provided by such tablets comes from the aspirin they contain (Ross, Tr. 6182). Consequently, the phrase "relief of aspirin" may be reasonably understood to mean that Aspercreme provides the ingredient aspirin (*i.e.,* that Aspercreme's relief comes from aspirin) (CXs 60B, 79A).

88. Other phrases used in the ads which suggest aspirin as an ingredient include "like aspirin itself" (*See* CXs 6–7) and a comparison between Aspercreme, a topical rub, and "regular" aspirin (CXs 2, 4). These phrases may reasonably be construed to mean that Aspercreme is a form of aspirin rub (Cohen, Tr. 210–12, 223–24).

89. Some Aspercreme ads use visual images to reinforce the aspirin content suggestion. For example, in CXs 1–4, a woman holds two aspirin tablets while saying that Aspercreme enables you to put the "strong relief of aspirin right where you hurt." The aspirin tablets in the woman's hand are then replaced by a tube of Aspercreme. Two images are evoked: a product which places aspirin tablets at the point of the pain, and a product which contains aspirin tablets in a cream form.

90. The determination that the brand name "Aspercreme" is capable of suggesting to a consumer that the product is a form of aspirin rub is reasonable. When an advertisement, obviously addressed to a target audience of arthritics and rheumatics, touts "Aspercreme" as a new rub which enables them to concentrate the "strong relief of two aspirin" right where you hurt most without upsetting your stomach, its clear, dominant message is that "Aspercreme" is, as the name suggests, a form of aspirin rub which relieves minor pains of arthritis and rheumatism without the stomach upset you get from taking aspirin in a tablet form.

91. The determination that the Aspercreme ads discussed above contain express or implied claims that the product is a form of aspirin

rub is supported by the advertisements [37] themselves viewed as a whole and is confirmed by expert testimony (*e.g.,* Cohen, Tr. 206–29, Silny, Tr. 771–72, 814–16; Ross, Tr. 5985–86, 5991, 6197–98), consumer research, other documents showing how self-regulatory bodies (the National Association of Broadcasters and CBS) and Thompson's own advertising agency viewed the ads (CXs 79, 80, 92, 116).

92. The copy tests and other consumer research regarding the ingredient inferences viewers are likely to draw from the brand name "Aspercreme" and some of the Aspercreme commercials is confirmatory of the foregoing determinations. Such consumer research includes:

a. The ASI Interlock Experiment (CX 26)
b. The ASI Theatre Test (CX 27)
c. The Mapes and Ross Test (CX 50)
d. The FRC Test (CX 35/RX 520)
e. The Lieberman Test (CX 32/RX 500)
f. The Video Storyboard Test (CX 51)
g. The Schneider Focus Groups (CX 52)
h. The Nicholas Focus Groups (CX 53)

Of the above, the two ASI Tests (CXs 26 and 27) were conducted for the FTC counsel, and the FRC Test (RX 520/CX 35) and Lieberman Test (RX 500/CX 32), for Thompson. All of these four tests were designed and conducted for use in this litigation. Generally speaking, these copy tests and other research show that a significant number of viewers took the Aspercreme commercials to suggest that Aspercreme contained aspirin.

93. The Mapes and Ross Test (CX 50), is a copy test on CXs 1 and 2 conducted in May 1979 for Ogilvy and Mather, Thompson's advertising agency for Aspercreme, and is the only copy test which predated this litigation and sheds some light on the ingredient issue.

94. Ogilvy and Mather, Thompson's advertising agency, concluded from the Mapes & Ross Test (CX 50) that a substantial number of respondents who viewed CXs 1 and 2 had misinterpreted the commercials to mean that Aspercreme contained aspirin. Specifically, the verbatim comments were reviewed by several Ogilvy and Mather employees who marked the comments as showing "confusion" regarding the ingredients in Aspercreme (*See,* CXs 45B–C, 93, 94, 95, 96, 97, 98 (Admissions No. 24–27)). In September 1979, Barbara Thompson, an employee from Ogilvy's research department, sent a memo (CX 116) to the head of Ogilvy's legal department detailing the percentages of viewers who had "misinterpreted" the ads to mean Asper-

creme contains [38] aspirin. According to CX 116, of those viewers who confirmed they had seen the ads, 30% who saw CX 1 ("Stand-Up Presenter") and 21% who saw CX 2 ("Visible Men") "misinterpreted" the ads to mean Aspercreme contains aspirin (CXs 45B, 116 (Admission No. 15)). *Also see* CPF 112)

95. Thompson's criticisms of the reliability of the Mapes and Ross Test (CX 50) during this trial are somewhat undermined by the fact that representatives of Thompson had discussed the Mapes and Ross Test during a meeting with its advertising agency, Ogilvy and Mather, and based on that discussion, Thompson decided which commercial to air (CX 99A). Thus, Thompson has relied on the Mapes and Ross Test to make an important business decision.

96. The ASI Interlock Experiment (CX 26) was designed specifically to measure consumers' ingredient inferences from the brand names of three products in the topical analgesics product class, Aspercreme, Ben Gay and Mobisyl (a TEA/S cream similar to Aspercreme). The responses to an open-ended question "What ingredient or ingredients, if any, are suggested by the brand name?" are summarized below:

	Ingredient Mentions (In percentage)			
	Aspercreme	Mobisyl	Ben Gay	Total Sample
	(N=120)	(N=66)	(N=73)	(N=259)
Aspirin	78%	8%	3%	39%
Creme	31	2	10	17
Mobil Oil/Gas/Motor Oil	–	12	–	3
Camphor	–	–	5	2
Heat	–	–	5	2
Penicillin	–	3	–	1
Silicone	–	3	–	1
Pain killer	–	–	4	1
Nengol	–	–	1	0
Benvereen	–	–	1	0
Benzedrine	–	–	1	0
Sedative	–	2	–	0
Benzoyl peroxide	–	–	1	0

(CX 26G, Table II).

97. The following tabulation of the ASI Interlock Experiment data demonstrates the ability of brand names of the [39] test products to suggest specific ingredients and dramatically confirms what common sense and daily experience would tell us about the brand name "Aspercreme":

Ingredient Type Mentions
(in percentage)

	Aspercreme	Mobisyl	Ben Gay
	(N=120)	(N=63)	(N=73)
Aspirin mentioned	78%	8%	3%
Other active ingredients without aspirin mentioned	0	5	19
Cream or other inactive ingredients without aspirin mentioned	5	17	11
No ingredient mentioned (Don't Know, None or Declined to Answer)	17	74	73

(CX 26J, Table IV).

98. Another conclusion suggested by the CX 26 data is that the product category (analgesic rub) alone does not generate an inference that the product contains aspirin or that the pain relieving ingredient in the product is aspirin. These results clearly show that the brand name "Aspercreme" produced a remarkably high level of aspirin mentions, while the names Ben Gay and Mobisyl showed low levels of aspirin mentions and that the name "Aspercreme" is capable of suggesting to many that the product contains aspirin (Cohen, Tr. 161–63; Silny, Tr. 771–72).

99. The purpose of CX 27, the ASI Theatre Test, was to investigate the effects of an Aspercreme commercial which contains an affirmative ingredient disclosure statement on viewers' perception of the products' ingredients, and specifically to determine whether such an advertisement (CX 9) effectively overcame the aspirin-content suggestion conveyed by the brand name "Aspercreme" (Cohen, Tr. 163–64; Silny, Tr. 773; CX 27B–C). In response to an unaided question, 17% of the survey respondents who remembered seeing CX 9 stated that CX 9 represented that Aspercreme contained aspirin. When an aided question was put, the proportion increased to 38% (CX 27F–H). [40]

100. The CX 27 data show that, in response to the unaided recall question ("what ingredient or ingredients, if any, did the commercial say Aspercreme [or Mobisyl] contained"), of the people who saw the Mobisyl commercial, only 1% thought Mobisyl contained aspirin, while 17% who saw the Aspercreme commercial containing an ingredient disclosure statement thought Aspercreme contained aspirin. In response to the aided recognition question (which read a list of ingredients to respondents and, as each ingredient was read, asked them whether that particular ingredient is contained in the product) only 5% of those in the Mobisyl group thought the product contained

aspirin, whereas 38% of respondents in the Aspercreme group thought Aspercreme contained aspirin. For every ingredient except aspirin, the recognition levels were statistically the same between the Aspercreme and Mobisyl groups (Cohen, Tr. 188–90; Silny, Tr. 814–15; CX 27G).

101. Thus, the ASI Theatre Test (CX 27) clearly shows that the tested commercial (CX 9) led more viewers to state that Aspercreme contains aspirin, despite the affirmative disclosure to the contrary, than did a competitive product in the same category. Significantly, more people thought Aspercreme contained aspirin (an ingredient the commercial says it does not have) than thought it contained salycin (an ingredient the commercial says it has). This indicates that the brand name Aspercreme creates a strong perception that the product contains aspirin and the affirmative ingredient disclosure statement is not effective in overcoming that perception (Cohen, Tr. 194–95; Silny, Tr. 814–16, 1068–69).

102. Respondents in the ASI Theatre Test (CX 27) were not limited to users of topical rubs or arthritis sufferers because it was a perception test. In such a test, there is no reason to believe that users and non-users of the product class would differ in their perceptions (Silny, Tr. 749, 778). Thompson's chief marketing witness, Dr. Ross, agreed that as a general principle of marketing research, usage or non-usage of the product category has no measurable impact on respondents' perceptions of what is represented in the test ad, and that in this study there were, in any event, no substantial differences between users and non-users in terms of their responses to the perception questions (Ross, Tr. 6234–35, 6240–42).

103. Thompson's other criticisms directed to the design and execution of CX 27 do not diminish the essential import of this ASI copy test (*See* RB 129–36; CPF 92–102).

104. Thompson, through its counsel (Davis and Gilbert), commissioned two copy tests of CX 9 for the purpose of this [41] litigation: The FRC Test (RX 520/CX 35) and the Lieberman Test (RX 500/CX 32). Davis and Gilbert retained Dr. Kenneth Warwick to design and execute the tests (Warwick, Tr. 5296). CX 9 contains an ingredient disclosure statement "Aspercreme contains salycin, a strong non-aspirin pain reliever." Dr. Warwick was aware of the possibility that the tests may be used in litigation and that he might be requested to appear as a witness (Warwick, Tr. 5364–71). Before the design and execution of the studies, counsel for Thompson showed Dr. Warwick a document that outlined the complaint allegations in this proceeding (*i.e.*, that the Aspercreme advertising implies that the product contains aspirin) (Warwick, Tr. 5371–73).

105. In the FRC Test (RX 520), while 2.9% of the respondents an-

swered "aspirin" in response to the unaided Question 1, "What was the name of the ingredient in the product you just saw advertised?", the aspirin ingredient answers increased to 22% in response to the aided Question 2, "Based on the commercial you just saw, does the product in the commercial contain aspirin?".

106. Question 2 is a straightforward and reasonable aided recall question and appropriate in light of the objective of the study. Although it suggests to a respondent that the product may contain aspirin and it can be answered in a yes/no fashion, it is not "leading" in the sense of signalling what the desired answer is.

107. The FRC Test (RX 520) shows that CX 9, an Aspercreme advertisement containing an affirmative ingredient disclosure statement, and shown under fairly optimal conditions for communication (respondents were told to pay attention, the ad was shown twice, and respondents were questioned immediately thereafter) led 3–22% of the respondents to say the product contains aspirin, and left an additional 10% confused as to whether the product contains aspirin (Cohen, Tr. 281–82; Silny, Tr. 841–42).

108. The Lieberman Test (RX 500) is the second copy test on CX 9 designed by Dr. Warwick, who also designed the FRC Test (RX 520). It was administered by Lieberman Research Suburban, Inc. ("Lieberman"). The reasons for conducting two copy tests on CX 9, both designed by Dr. Warwick, are not clear in this record. However, Dr. Warwick had not intended to do two tests in the outset (Warwick, Tr. 5401; CX 45Z–019 (Admission No. 46)). The decision to do the Liberman Test was made after FRC was completed and after Dr. Warwick communicated the FRC results to Davis and Gilbert. The Lieberman Test was then done at the request of Davis and Gilbert (CX 45Z–030 (Admission No. 64); Warwick, Tr. 5403). [42]

109. Dr. Warwick did not include in the Lieberman questinnaire a direct aspirin ingredient question which he had included in the FRC Test. Although Dr. Warwick testified that this was an improvement over the FRC Test design, which he characterized as "flawed," the evidence is also consistent with the conclusion that the direct ingredient question was dropped because it had produced results unfavorable to Thompson in the FRC Test.

110. A major defect in the Lieberman questionnaire is that the open-ended question ("What was the name of the ingredient in the Aspercreme—the product advertised?") was not followed by a probe or any aided question (in contrast to the FRC Test which had the direct, close-ended ingredient question) (CX 34B).

111. Also, as in the FRC Test (RX 520), the question in Lieberman was biased in that it suggested that there was only one ingredient, so

that respondents were permitted to answer with only one ingredient (Cohen, Tr. 263–64; Silny, Tr. 839).

112. Considering the fact that the test audiences had just twice seen CX 9 which states "Aspercreme contains salycin, a strong non-aspirin pain reliever," it is somewhat surprising that only 25% of the respondents named salycin (RX 500E). In any event, a probe would have made it possible for respondents to mention aspirin as well, since a salycin response does not negate the possibility that respondents may have thought the product also contained aspirin (Silny, Tr. 834). It is accepted in marketing research that an open-ended question is not respresentative of everything stored in respondents' minds (Silny, Tr. 835). As Dr. Ross, Thompson's marketing witness, stated, open-ended questions lead most respondents to play back only one theme or point. They do not draw out a complete or exhaustive list of all the things respondents may have on their minds. Rather, respondents will play back the dominant theme or primary impression and, having done that, will probably stop (Ross, Tr. 6260).

113. In the final analysis, there is no way to test whether a consumer does or does not take a certain meaning from an ad other than putting that direct question to the consumer and asking the consumer to affirm or deny that the claim was made (Ross, Tr. 6260–63). In other cases, Dr. Ross has relied on aided, close-ended, ultimate questions, such as the question in a *Sterling Drug* study which read, "Did the advertisement suggest or did it not suggest that Bayer worked better than any other aspirin" (Ross, Tr. 6264). And another Thompson witness agreed [43] that a probe following an open-end question is common and accepted in marketing research (Silver, Tr. 5941). The initial reasoning regarding questionnaire design that occurred to Dr. Warwick, a marketing researcher with 20 years' experience, was that since he was interested in aspirin, he should ask a direct question about aspirin (Warwick, Tr. 5457–58, 5470).

114. An aided or close-ended question (as in the FRC Test) may well have cleared up the confusion caused by the wording of Question 1, and would have given respondents a further opportunity to say whether aspirin as well as salycin was an ingredient (Silny, Tr. 834–35). Because no aided or close-ended question was asked, there is no way of knowing how much information respondents had in their minds that was not revealed in response to Question 1 (Cohen, Tr. 276).

115. In any event, the Lieberman Test (CX 32/RX 500) shows that CX 9, an Aspercreme commercial which contains a non-aspirin ingredient disclosure statement led, on the basis of an unaided question, about 3% of the test audience to name Aspirin as an ingredient in Aspercreme (RX 500C). This is substantially lower than the 17% level

produced by an unaided question in the ASI Theatre Test (CX 27), which also tested CX 9.

116. In sum, the three copy tests on CX 9 in evidence (CX 27, RXs 500 and 520), taken together, are generally confirmatory of my view that the non-aspirin ingredient disclosure statement contained in CX 9 is woefully insufficient.

(a) *The Video Storyboard Test (CX 51)*

117. CX 51, the Video Storyboard Test, was a copy test conducted for Thompson to measure the relative persuasiveness of CX 1 and CX 2. The methodology involved a shopping mall intercept approach in Bridgeport, Connecticut. The sample consisted of 100 persons selected from among the shoppers. Respondents were shown one of the test commercials, and the questionnaire was administered immediately thereafter (CX 51N).

118. The Video Storyboard Test does not shed any light on the issue whether there is an aspirin content representation in the tested ads. It was designed specifically to find out what main idea in the ad is of most interest to viewers (Cohen, Tr. 229–30; Ross, Tr. 6310–11). The questionnaire primarily asked respondents how interested the ad made them in trying Aspercreme, and what the main idea in the ad was (CX 51N). The study did not ask whether or not the advertisements suggested [44] that the product contains aspirin. It is obvious that the main idea of the Aspercreme ads is relief of arthritis pain (Cohen, Tr. 231). People might have given that answer on this test and still thought that a secondary idea of the ad was that the product contains aspirin (Cohen, Tr. 229–30).

119. Thompson's marketing witness Dr. Ross asserted that if respondents had perceived aspirin as an ingredient in Aspercreme as a result of seeing CX 1 or CX 2 in this test, the questionnaire afforded them opportunities to express this (Ross, Tr. 6002–03). However, in order to make the statement that Aspercreme contains aspirin, the respondent would have to believe that that was the one main idea the commercial was trying to get across (Cohen, Tr. 231). It cannot be determined from the responses to this test whether the ads led these respondents to the inference that aspirin is an ingredient in Aspercreme. To answer that question, a direct ingredient question must be included as was done in the ASI and FRC tests (Cohen, Tr. 232; CX 27 and RX 520).

(b) *The Schneider Focus Groups (CX 52)*

120. CX 52, entitled "An Analysis of Group Sessions on Aspercreme" (the Schneider focus groups), is a report of two focus group

sessions conducted for Thompson by David L. Schneider, Ph.D. (CX 52).

121. Qualitative research (such as the focus group), while lacking the "respresentativeness" of other types of marketing studies such as surveys, copy tests, and controlled experiments, is a widely used form of marketing research today. Trained moderators probe in very careful ways to elicit answers to the research questions (Cohen, Tr. 106).

122. The respondents in CX 52 had been given Aspercreme for a two week period of trial. All suffered from arthritis or some form of muscular aches or pains on a continuing basis (CX 52B–C). They were not shown any advertisements for Aspercreme, but had the Aspercreme package during the trial period. After the two week trial period, a number of people either thought the product they used contained aspirin or were confused as to the product's aspirin content (Cohen, Tr. 197–99, 552; CX 52K–N).

123. For example, CX 52 noted that respondents had relief expectations based on the idea that the product contained aspirin (CX 52M). Among the quotes cited were the following: "I wondered if it would be able to work since aspirin is [45] something you swallow"; "I figured they'd ground it up and mixed it with cream till it was smooth"; "When I saw it and saw 'Asper', I right away thought it must also have aspirin in it" (CX 52L).

(c) *Nicholas Research Focus Groups (CX 53)*

124. CX 53 is a report by Nicholas Research on three focus group sessions conducted for Thompson involving Aspercreme. No advertisements were shown to respondents, but they had been given Aspercreme packages to use for a ten-day trial period (CX 53F). The objectives of the study were to gain insight regarding respondents' arthritis symptoms, and the products they currently used for arthritis, and to determine their reactions to Aspercreme vis-a-vis other over-the-counter remedies after use (CX 53D).

125. A number of respondents in CX 53 believed that the product contained aspirin (Cohen, Tr. 552). For example, the moderator observed that respondents "were attracted to the name Asper/Aspercreme because it has aspirin in it, or it is full of aspirin" (CXs 53Z, Z–056). The moderator also reported that several respondents felt since Aspercreme contained aspirin they could substitute it for aspirin (CXs 53Y, Z–053). One respondent said, "I didn't take any aspirin [during the trial period]—the name—Aspercreme—I said to myself, 'Maybe it has aspirin in it—I'd be applying the aspirin to the localized area instead of taking it internally.' " And another respondent noted, "Don't need to take aspirin, since this contains aspirin in it" (CX 53Z–053; Cohen, Tr. 200).

(2) *Complaint Paragraph 10 (b):* The claim that Aspercreme is a recently developed drug product.

126. Thompson has represented, directly or by implication, that Aspercreme is a recently discovered or developed drug product. This representation was made in CXs 6–8, 10–11. The fact that Aspercreme advertisements made this representation is evidenced by the advertisements themselves and is corroborated by expert testimony (*See* CXs 6–8, 10–11; Cohen, Tr. 249–50).

127. The representation that Aspercreme is a newly developed product is made through the use of a bold headline which states "At last! A remarkable breakthrough for arthritis [46] pain: Aspercreme" (CXs 6–7, 10–11; Cohen, Tr. 250). If Aspercreme is a "remarkable breakthrough" which has "at last" been achieved, then consumers would reasonably conclude that it is newly discovered (Cohen, Tr. 250).

128. In CX 8, the headline states that "There's always been aspirin . . . Now there's Aspercreme." This headline suggests that the product is newly developed, and the message is reinforced in the first paragraph of the test, which reads: "Aspirin has been helping sufferers of minor arthritis pain for years. Now there is a different way to get relief. Aspercreme" (Cohen, Tr. 250).

(3) *Complaint Paragraph 10(c):* The claim that valid scientific studies have proven that Aspercreme is more effective than orally-ingested aspirin for the relief of minor pain of arthritis or rheumatic conditions.

129. Thompson has represented, expressly and by implication, that valid studies have scientifically proven that Aspercreme is more effective than orally-ingested aspirin for the relief of minor pain of arthritis and rheumatic conditions. This representation was made in CX 7 and CX 8, a fact which is evidenced by the advertisements themselves (*See* CXs 7–8).

130. CX 8, a print ad, explicitly states that Aspercreme was "tested" and "proved" more effective than oral aspirin in treating tendonitis, bursitis, muscular, rheumatic and arthritic pains. CX 8 goes on to discuss a particular test done by "a leading specialist in arthritis and rheumatism," and describes that test as a "controlled clinical test" (*See* CX 8). From these statements, consumers could reasonably understand the "test" to be valid scientific proof of the proposition asserted in the ad—that Aspercreme is faster and better than aspirin. CX 7, another print ad, similarly represents that Aspercreme has been "tested," and that its superiority demonstrated by scientific tests conducted by "a leading arthritis specialist."

(4) *Complaint Paragraph 12(a):* The claim that Aspercreme is an effective drug for the relief of minor pain of arthritis and its symptoms.

131. Thompson has represented, expressly or by implication, that Aspercreme is an effective drug for the relief of minor [47] pain of arthritis and its symptoms such as inflammation. This representation was made in all of the advertisements in evidence, including CXs 1–22 and 37. Respondent does not dispute that it made this claim (*See* RB 142). However, none of the Aspercreme ads in evidence contain a claim that Aspercreme cures arthritis.

(5) *Complaint Paragraph 12(b):* The claim that Aspercreme is as effective a drug as orally-ingested aspirin for the relief of minor pain of arthritis and its symptoms.

132. Thompson has represented, expressly or by implication, that Aspercreme is as effective a drug as orally-ingested representation was made in all of the Aspercreme ads in evidence, including CXs 1-22 and 37. Respondent does not dispute that it made this claim (*See* RB 142-43). However, none of the ads in evidence contain a claim that Aspercreme cures arthritis.

(6) *Complaint Paragraph 12(c):* The claim that Aspercreme is a more effective drug than orally-ingested aspirin for the relief of minor pain of arthritis and its symptoms.

133. Thompson has represented, expressly or by implication, that Aspercreme is more effective than aspirin tablets because it works faster than aspirin tablets, or it works without aspirin's side effects such as stomach upsets, or both. Aspercreme ads in evidence which made such a claim include CXs 1–11, 21–22, and 37.

134. Many of the Aspercreme advertisements in evidence represent that Aspercreme provides the same relief as oral aspirin, only faster and/or with fewer side effects (Ross, Tr. 6164. *See* Cohen, Tr. 251, 253, 254; CXs 6–8). Consumers are interested in the end benefit of a product like Aspercreme (Ross, Tr. 6200), and the end benefit of a product which provides faster relief with fewer side effects is that it is more effective (Ross, Tr. 6164–65; Cohen, Tr. 254). Clearly, then, a claim of faster relief or fewer side effects is a claim of greater effectiveness.

135. In CX 8, the subheading states that Aspercreme "Works faster, safer than aspirin." This assertion of superior speed [48] and safety is a representation of superior effectiveness (Cohen, Tr. 254). The text of the ad then goes on to reinforce this message by explicitly stating

that "Aspercreme actually relieves pain, faster, safer, better than aspirin" (CX 8).

136. The claim of superior speed, which would be perceived as superior effectiveness (*See* F. 134, *supra*), is also made in CXs 2, 4, 6–7 (Cohen, Tr. 251, 253–54). CXs 6 and 7 both contain the direct statement that Aspercreme works faster than oral aspirin (Cohen, Tr. 253–54; CXs 6–7). Moreover, CX 7 explicitly states that Aspercreme was found to be "faster and more effective than aspirin" (Cohen, Tr. 254; CX 7). In CXs 2 and 4, Aspercreme's superior speed is demonstrated by the video portion of the commercials. In both instances, the video suggests that Aspercreme reaches the point of pain faster than oral aspirin since it goes directly to the point of pain instead of having to work its way through the body (CXs 2, 4; Cohen, Tr. 251).

137. Another element in Thompson's advertising that communicates superior effectiveness is the claim that Aspercreme, in contrast to oral aspirin, provides "concentrated relief" (Cohen, Tr. 252, 254–55; CXs 78A, 88C. *See* CXs 2, 4, 6–7, 10–11). A number of Thompson's advertisements represent that Aspercreme concentrates the drug directly at the point of pain, as opposed to regular aspirin which diffuses throughout the body (Cohen, Tr. 252, 254–55; CX 78A, 88C). Such a representation could reasonably create the impression that the relief provided at the point of pain by a concentrated product (*i.e.*, Aspercreme) would be superior to that provided by a product which travels throughout the body (*i.e.*, regular aspirin).

138. Confirmatory evidence that CX 2 conveyed a superiority message is found in the Mapes and Ross copy test (Cohen, Tr. 252–53; CX 50). The copy test showed that 44% of the participants who saw "Visible Men" (CX 2) played back a theme relating to the comparative superiority of Aspercreme over tablets (Cohen, Tr. 252–53; CX 50I). Many of these responses went to efficacy, with 27% of the respondents playing back "faster than tablets," 5%, "better than tablets," and 10%, "more effective than tablets" (CXs 50P, V–Z–031).

139. Further confirmation that the challenged superiority claims were made is provided by letters from NBC and the NAB (*See* CXs 78A, 88C). Both of these specialists in the field of communications wrote to Thompson to indicate that a claim of superiority to aspirin was being made (*Id.*).

140. Dr. Ross, Thompson's expert witness, agreed that a claim of faster relief, or relief with fewer side effects, is a [49] superiority claim. He stressed, however, that the superiority claim in these Aspercreme ads referred not to the product ingredients or formulation but to the modes of product application—topical versus oral (*See* Ross, Tr. 6165). However, to the consumer, what is important is the end benefit of the product (pain relief), not how that benefit is achieved

(Ross, Tr. 6201), and a superiority claim in these Aspercreme ads will be understood to mean that Aspercreme is a superior pain reliever than aspirin tablets. By the same token, an ad claim which compares Aspercreme with aspirin and says Aspercreme is faster or safer than aspirin tablets is a "comparative claim" in a real sense, although it does not name the aspirin tablets being compared by brand name.

(7) *Complaint Paragraph 12(d):* The claim that Aspercreme is an effective drug for the relief of minor pain of rheumatic conditions.

141. Several Aspercreme advertisements in evidence represented, expressly or by implication, that aspercreme is an effective drug for the relief of minor pain of rheumatic conditions. They include CXs 7–8, 13–14, 16–20. Respondent does not dispute that some Aspercreme ads contain a claim that Aspercreme is effective for the relief of minor pain of rheumatic conditions (RB 142–43). However, none of the Aspercreme ads in evidence suggests that Aspercreme cures rheumatic diseases.

(8) *Complaint Paragraph 12(e):* The claim that Aspercreme acts by directly penetrating through the skin to the site of the arthritic disorder.

142. Many Aspercreme ads in evidence represented, expressly or by implication, that Aspercreme acts directly by penetrating through the skin to the site of arthritic pain. They include CXs 1–4, 6–11, 21–22, 37. Respondent does not dispute that it has represented that Aspercreme penetrates directly from the skin to the point of arthritic pain (RB 143–44). [50]

(9) *Complaint Paragraph 12(f):* The claim that Aspercreme has no side effects.

143. It is true that several Aspercreme advertisements expressly represented that Aspercreme has "no" side effects (CXs 6–8, 10–11). However, when viewed as a whole, each ad was clearly saying no more than Aspercreme does not cause stomach upsets as oral aspirin is known to do. In my view, these ads can be reasonably construed to say (1) that Aspercreme is a topical rub and does not cause stomach upsets and other side effects associated with aspirin tablets, or (2) that Aspercreme is a safe product and does not have any side effects to worry about. In the context of these ads, a claim of "no side effects" will be taken to mean "no *significant* side effects."

(10) *Complaint Paragraph 14:* The claim that Thompson possessed and relied upon a reasonable basis for the efficacy and safety claims contained in Aspercreme advertisements.

144. Thompson has represented, directly or by implication, that it possessed and relied on a reasonable basis for Aspercreme's efficacy and safety claim contained in the advertisements in evidence, including CXs 1–22 and 37. This determination is evidenced by the advertisements themselves and supported by expert testimony (Cohen, Tr. 256–59; Ross, Tr. 6461).

145. Consumers generally believe that there must be a basis for efficacy and safety claims for OTC drugs or advertisers would not be allowed to make them (Cohen, Tr. 256–59; Ross, Tr. 6461). Consumers assume that this basis would be the kind of support or proof that would be acceptable to the medical/scientific community or the FDA (Cohen, Tr. 256–57; Ross, Tr. 6462). Hence, all Thompson's advertisements which made efficacy or safety claims implied that there is an appropriate scientific basis for these claims.

146. Several Aspercreme ads in evidence also reinforce the reasonable basis representation through the use of various trappings of scientific support. These trappings include explicit representations of "controlled clinical test" (CX 8), and other clinical proof (CXs 7, 20, 37), references to support in the medical community (CXs 7–8), and the use of a scientific model (CXs 2, 4). [51]

C. *The Use Of The Brand Name "Aspercreme" In Advertisement: Complaint Paragraph 16*

147. It is found that through the use of the brand name "Aspercreme" in advertisements, labels and promotional material, Thompson represented, directly or by implication, that Aspercreme contains aspirin as alleged in Paragraph 16 of the complaint. This determination is based on the advertisements and related consumer research in evidence and expert testimony regarding the use of the "Aspercreme" brand name.

148. The determination that many consumers are likely to take from the brand name "Aspercreme" a meaning that the product contains aspirin is reasonable and conforms to our common sense and daily experience. This view is also confirmed by the record evidence pertaining to this issue.

149. The brand name is the most salient part of a commercial (Cohen, Tr. 549). Consumers are more apt to be aware of and recall brand names than specific copy points made in advertising (Ross, Tr. 6317–19). The brand name is a more powerful stimulus and will be

remembered by consumers far longer than any specific advertising or copy points (Cohen, Tr. 559; Ross, Tr. 6319).

150. Respondent's expert witnesses do not dispute that a brand name is not only capable of communicating information about product ingredients but also capable of playing a role in creating beliefs about a product (Ross, Tr. 6315–17), especially during the product's introductory phase (Ross,Tr. 6341). However, they testified that most consumers will not construe "Aspercreme" to mean that the product contains aspirin (Ross, Tr. 5970, 5983–85; Silver Tr. 5797–99, 5804, 5815).

151. Dr. Ross suggested that a brand name immediately acquires a "secondary meaning" (which he defined as simply identifying or standing for the particular product), and that when it does, any associations the brand name may originally have triggered are immediately lost (*See* Ross, Tr. 5963, 6083).

152. Dr. Ross also took the position that a brand name is not deceptive where the consumer can, through information or experience, determine for him or herself whether or not the association suggested by the name is true (*See* Ross, Tr. 6333). This approach confuses the issue of whether a given advertisement is deceptive with the issue of whether the initial deception can be cured by other information or consumer's use [52] experience. In this connection, Dr. Ross agreed that the consumer will not generally search for further ingredient information in order to verify what he or she has been told in advertising (Ross, Tr. 6370. *Also see,* F. 179–86, *infra*).

153. On the other hand, Dr. Ross agreed that the brand name Aspercreme, in the context of an ad for an analgesic product, may convey to some consumers that the product contains aspirin, as distinguished from an ad where the brand name was "X" (Ross, Tr. 6197–98). Dr. Ross also recognized that if a consumer is in an "ingredient" frame of mind and comes upon the brand name Aspercreme in an analgesic context, "Aspercreme" would be associated with aspirin (Ross, Tr. 6231, 6277–78).

154. Mr. Jasper of Ogilvy and Mather testified about the creation of advertising for respondent. When asked upon cross-examination what name he would choose to indicate to consumers that a product was an aspirin-containing cream, Mr. Jasper felt that the most effective, straightforward name would be Aspirincreme, or Jay's Aspirincreme (Jasper, Tr. 4838–39). He then conceded that it would be reasonable for an advertiser/marketer to use a phonetic or alphabetic variation of the name Aspirincreme to convey the aspirin content message, and that the name Aspercreme could be viewed as such an alphabetic or phonetic variation (Jasper, Tr. 4839–40). Thompson's witnesses generally agreed that the name Aspercreme might sound

like aspirin to consumers (*See* Jasper, Tr. 4838–40; Ross, Tr. 6350; Silver, Tr. 5689, 5793–95).

155. Complaint counsel's expert witnesses, Drs. Cohen and Silny, both testified that the name Aspercreme strongly implies that the product contains aspirin (Cohen, Tr. 161–62, 549; Silny, Tr. 771–72). These opinions are based on their experience and the consumer research in evidence, including CX 26.

156. In the ASI Interlock experiment (CX 26), a controlled study designed to measure the impact of the brand name, some 78% of the respondents answered an open-ended question about ingredients by stating that the name Aspercreme suggested or implied that aspirin was in the product (CX 26G, F. 96, *supra*). By contrast, when the same generic product description was given to the Ben Gay and Mobisyl groups, only 3% and 8% responded that aspirin was suggested by those names. Thus, the generic product category, which was identified in the experiment by the description "for the relief of arthritis pain," does not generate the inference that aspirin is an ingredient. Although respondent's experts dismissed CX 26 as a word association game, it is reasonable to conclude that it is the name Aspercreme which led to the strong inference of aspirin content (Cohen, Tr. 161–63; Silny, Tr. 771, 1084). **[53]**

157. Two reports of focus group sessions (CXs 52 and 53) also support the proposition that the brand name Aspercreme is capable of leaving some consumers with the impression that the product contains aspirin. CX 52, a report of two focus groups done by David Schneider (*See* F. 120, *supra*), notes that "In a number of instances the *name* made one especially eager to try it, *for the aspirin association was evoked*" (CX 52K (emphasis in original)). The importance of the name's aspirin association is repeatedly emphasized in the report (*See* CXs 52K, M, N). Specific comments made by a number of consumers during the focus group sessions lends support to the conclusion that the brand name Aspercreme suggests aspirin to some consumers (*See* CX 52L). For example, a consumer stated: "When I saw it and saw 'Asper', I right away thought it must also have aspirin in it . . ." (CX 52L). The focus group participants had used Aspercreme for two weeks prior to the focus group sessions.

158. CX 53 is a focus group report by Nicholas Research (*See* F. 124, *supra*) and it provides further support for the conclusion that the name Aspercreme leads to the inference that the product contains aspirin (Cohen, Tr. 199). This focus group study was conducted at a different time and by a different moderator than CX 52, again with people who had used the product. CX 53 concludes that "others [*i.e.*, other respondents] were attracted to the name 'Asper/Aspercreme' because it has 'aspirin' in it" (CX 53Z, Z–056). The report also contains

the comments of several consumers who felt that, since Aspercreme had aspirin it it, they could take it instead of oral aspirin (CX 53Z–053).

159. Further evidence of the brand name's impact is provided by CX 27, the ASI Theatre Test. This study showed that the Aspercreme commercial tested (CX 9) led more viewers to state that Aspercreme contains aspirin than did a commercial for a competitive product, despite the presence of an affirmative ingredient statement "Aspercreme contains salycin, a strong non-aspirin pain reliever" in CX 9. It is also noteworthy that more people thought Aspercreme contained aspirin than thought it contained salycin, the very ingredient named in CX 9 (Cohen, Tr. 194–95).

160. The determination that the name Aspercreme suggests aspirin content is also confirmed by the fact that Thompson's own advertising agency recognized that the name would be so interpreted (*See* CXs 54Z, 55B–E, 60B). For example, in one agency memorandum discussing the aspirin content claim, it was noted that altering the "relief of aspirin" phrase would do nothing about "possible rub-off from the brand name" (CX 60B). Another agency strategy document refers to the "the 'aspirin' component of Aspercreme" (CX 54Z). [54]

161. From all of the foregoing, it is found that the brand name "Aspercreme" for an analgesic product is likely to mislead a significant segment of the target group (consumers of OTC analgesic drugs) into believing that the product contains aspirin.

D. *The Presence Of Aspirin Is A Material Fact In Advertisements Of An OTC Topical Analgesic Product Directed To Consumers Who Suffer From Minor Pains Of Arthritis And Rheumatism*

162. The presence of aspirin in an over-the-counter analgesic product is a material fact to consumers, particularly to arthritics, because aspirin is a commonly known pain reliever and widely associated with the relief of minor pain and other symptoms of arthritis. Many arthritics know that aspirin is a drug of choice for the treatment of minor arthritic pain and also that orally-ingested aspirin can cause stomach discomfort and other side effects. A topical product which provides aspirin relief by the external route without undesirable side effects of orally-taken aspirin would be highly material to those who suffer from minor pain and other symptoms of arthritis and who desire to avoid side effects of aspirin tablets. Essentially, Thompson does not dispute the foregoing proposition (*e.g.*, Ross, Tr. 6370–71, 6373; Silver, Tr. 5694, 5841–42; Warwick, Tr. 5323, 5390–91, 5395; CXs 54D, Z–005, Z–007).

163. The Lieberman Study (RX 500) and the FRC Study (RX 520), both conducted for respondent for use in this litigation, also contain

data which show a significant portion of the test subjects, and a majority of arthritics, preferred an aspirin product over a non-aspirin product for pain relief. In FRC, some 39% said they preferred aspirin products (Warwick, Tr. 5333–34), while in Lieberman, which tested only arthritics, some 53% expressed a preference for an aspirin product (Warwick, Tr. 5333–34; CX 32F). These are substantial magnitudes (Ross, Tr. 6371–72). Other consumer research evidence in the record also confirms the importance of aspirin content in analgesic products to consumers in general and arthritics in particular (CXs 50Z–005, Z–016, 52I–J, 53Z–025–29, 59O).

164. The opinion of Ms. Silver, Thompson's advertising expert, that the materiality of aspirin content is limited to internally-taken products and does not extend to a topical drug such as Aspercreme because consumers generally take topical products less seriously than orally-taken products (Silver, Tr. 5844–45) is contrary to the weight of evidence in this record. [55]

E. *Respondent's Argument That The Various Ingredient Statements Printed On Aspercreme Packaging Would Have Effectively Disabused Consumers Of Any Notion They May Have Taken From Aspercreme Advertisements That Aspercreme Is An Aspirin Product Is Contrary To The Evidence And Is Insufficient As A Matter Of Public Policy Against False Or Misleading Advertising*

165. Respondent suggests that since all Aspercreme packages from 1976 to the present, in one form or another, informed the purchaser that Aspercreme does not contain aspirin, consumers were not misled by the advertisements challenged in this proceeding (*See* RPF 304–15).

166. The law is long-settled that when the initial contact between a seller and buyer occurs through a deceptive drug advertisement, Sections 5 and 12 of the Federal Trade Commission Act are violated even if the truth is subsequently made known to the purchaser through information given on the label. *Carter Products, Inc. v. FTC*, 186 F. 2d 821 (7th Cir. 1951). In my view, the proposition that a marketer may mislead consumers in advertising provided the truth is disclosed to the purchaser at the time of purchase is utterly incompatible with any notion of truthful advertising and is unacceptable.

167. In any event, the information printed on Aspercreme packages was at best confusing and did not say unequivocally that Aspercreme does not contain aspirin until December 1982, almost two years after the administrative complaint was issued in this proceeding (*See* F. 169–78, *infra*).

168. Furthermore, the evidence is clear that consumers generally obtain their product information from advertising and that a large

portion of consumers do not read packaging information for ingredient information (*See* F. 180–82, *infra*).

169. RX 276 shows an Aspercreme package used in 1976, when Aspercreme was acquired from Sperti Drug Products, Inc. A two-line statement in small print at the bottom of the front panel states: "Aspercreme manifests its activity through absorption of an accepted analgesic chemically similar to aspirin" (RX 276A). The ingredient statement on the back panel states: "Active ingredient: 10% Triethanolamine Salicylate." In a large circle just below the ingredient statement, the following statement is printed: [56]

Aspercreme manifests its activity through absorption of an accepted analgesic chemically similar to aspirin. This externally applied analgesic works as effectively in giving temporary relief as many internal pain relievers without stomach upset or other undesirable side effects. Aspercreme produces its amazing results without the unnecessary sensation of heat.

170. RX 277 shows an Aspercreme package used by Thompson after January 1977. A printed statement on the front side (the lower half of RX 277B) and placed below the prominent "ASPERCREME" logo reads "An effective, deep-penetrating aspirin-like analgesic for temporary relief of occasional minor pains of ARTHRITIS, RHEUMATISM, BACK & MUSCULAR ACHES." At the bottom of the same panel, another statement in smaller print states: "Aspercreme manifests its activity through absorption of an accepted analgesic chemically similar to aspirin."

171. On the top side of the package (the middle segment of RX 277B), a prominent statement covering almost one half of the panel reads:

delivers an aspirin like*
analgesic directly
to the point of pain
*Salicylate

172. The upper 5/6 of RX 277B shows the back of the display panel and package forming a large, single panel. The statement shown on the top side of the package and quoted in the preceding F. 169 is repeated in smaller type. This statement is followed by (in much smaller type):

An effective, deep-penetrating aspirin-like analgesic for temporary relief of occasional minor pains of ARTHRITIS, RHEUMATISM, BACK & MUSCULAR ACHES.

On the bottom side of the package (the middle portion of RX 277B);

a statement appearing above the ingredient statement reads in part: [57]

> Aspercreme manifests its activity through absorption of an accepted analgesic chemically similar to aspirin . . .

173. RX 278 shows an Aspercreme package bearing an expiration date "EXP APR 82" (RX 278B). The phrase "aspirin-like analgesic" appears four times: once prominently on the front display panel (top third of A), once in smaller type on the front side of the package (bottom third of A), and twice on the back panel (upper two-thirds of B). The phrase "an accepted analgesic chemically similar to aspirin" appears twice: once on the top side in small type, and once in much smaller type on the back panel.

174. RX 279 is an Aspercreme package bearing an expiration date "EXP 1/85" and is said to have been created in February 1981 (RPF 307). The front of the display panel ("fifth display panel") states prominently in red:

> ARTHRITIS RELIEF
> without aspirin

On the front side of the package, "relief without aspirin" is repeated in white print on brown background, to the right of which appears a statement "contains SALICYN, a strong non-aspirin pain reliever."

On the back panel, "RELIEVES PAIN FAST DOES NOT CONTAIN ASPIRIN" appears in white print on brown background in an oval inset, to the right of which appears a statement "Aspercreme delivers an effective non-aspirin analgesic directly to the point of pain." ". . . its strong, effective non-aspirin pain reliever" appears again in a smaller print.

The statement "Arthritis Pain Medication RELIEF WITHOUT ASPIRIN" appears on the bottom panel as well as on both the top and bottom closures of the package. Thus, the phrase "relief without aspirin" appears five times on RX 279.

175. RX 280 is an Aspercreme package for the 1.25 ounce size and was adopted in early 1981. The printed statements are almost identical to those of RX 279 in content and layout.

176. CPXs 5, 6 and 7 are Aspercreme packages which were purchased by complaint counsel in local drug stores during 1982. The printed statements contain such phrases as "Arthritis [58] relief without pills," "contains Salycin, a strong non-aspirin pain reliever," and/or "aspirin-like analgesic." However, none of them contain the phrase "Arthritis relief without aspirin," "Relief without aspirin," or "Does not contain aspirin" which were printed on RXs 279 and 280.

177. RPXs 3 through 6 are current Aspercreme packaging for the full line (the 3 ounce, 1 1/4 ounce and 5 ounce cream and the 6 ounce lotion (RX 286C)). RPX 3 was filed in the Thompson production department in August 1982 and appeared on some retail shelves as early as December 1982. RPXs 3 through 6 are expected to replace Aspercreme packaging on the retail shelves as existing product is exhausted (RX 286C).

178. RPXs 3 through 6 state in bold letters on the front and back of the package, including the fifth display panel: "without aspirin"; "aspirin-free"; "does not contain aspirin"; and "non-aspirin."

179. Respondent's principal advertising and consumer psychology expert witnesses, Dr. Ivan Ross and Ms. Jacqueline Silver, both testified that the package information would be read by those consumers who are interested in ingredients and that those who read it will understand that Aspercreme is not an aspirin product from the clear and prominent disclaimer statements printed on the package (*See* Ross, Tr. 6069–80; Silver, Tr. 5668–69, 5737–60, 5895–96, 5916–20).

180. Dr. Joel Cohen, complaint counsel's principal marketing expert, testified that, as a general principle, product labels are not an important source of product information for consumers and that advertising is a more important and dominant source of such information (Cohen, Tr. 244–45). In support of his expert opinion on the relative roles of advertising and labeling, Dr. Cohen relied on a FDA study entitled "Consumers and Medication." That study, based on a national probability survey, showed that in response to a question asking where people get their information on over-the-counter medicines and remedies, 43% replied advertising, while only 13% said labels (Cohen, Tr. 244–45). The survey also shows that older people are less likely to read labels than younger people (Cohen, Tr. 249). Arthritics are more likely to be older people. Older people are also likely to have a harder time reading labels, and may avoid reading labels in stores (Cohen, Tr. 247–48, 319; Silver, Tr. 5743). There is also a growing trend in the country to sell over-the-counter drugs in supermarkets. When people go to the supermarket they are not likely to spend time reading package labels because they generally would have a large number of items to buy (Cohen, Tr. 247). **[59]**

181. Thompson's witness, Dr. Ross, referred to another FDA study, and discussed the responses to two questions. The first asked "do you read the label for ingredients" and the second asked "whether label reading is necessary or important" (Ross, Tr. 6384, 6386–87). Although people view it as socially desirable to read labels (Ross, Tr. 6384–85), and such questions tend to bias the data by stimulating affirmative responses (Ross, Tr. 6392–93), 38% of the respondents

answered "no" or only "sometimes" to the question on the importance of label reading (Ross, Tr. 6385).

182. In another study referred to by Dr. Ross (the Houston and Rothschild study) label-reading behavior was observed and timed in a store environment (CX 407G). The study concluded that consumers do not read labels, even when advertising encouraged them to do so. The study found that consumers' knowledge about the product was enhanced only when they were provided with information in advertising (Ross, Tr. 6393–94; CX 407N–O). Dr. Ross also agreed that unless consumers have a special interest or concern, they are not apt to attend to what is on a package (Ross, Tr. 6358).

183. Dr. Cohen also testified that if a consumer is convinced by the advertising that the product has a certain ingredient, he or she is less likely to read the label for ingredient information (Cohen, Tr. 419). Since aspirin is among the most familiar OTC drugs, to the extent a consumer is led by advertising to think that a product contains aspirin, he or she is less likely to read the label for ingredient information (Cohen, Tr. 260–61, 326).

184. Dr. Cohen also testified generally that, even to those who do take the time to read the package information, such phrases as "aspirin-like," "similar to aspirin" or "contains Salycin, a strong non-aspirin pain reliever" do not specifically and unequivocally say that Aspercreme does not contain aspirin and merely tend to confuse the consumers (Cohen, Tr. 317–19, 323–24, 5743–44).

185. Ms. Silver, respondent's expert witness, agreed that the phrase "without pills" (CXP 5), is not a statement regarding ingredients (Silver, Tr. 5899) and that those packages which do not contain clear aspirin disclaimers like "without aspirin" or "does not contain aspirin" are less likely to convey a no-aspirin message to a reader (Silver, Tr. 5903–04). And, as Dr. Ross admitted, the phrase "contains Salycin, a strong non-aspirin pain reliever" does not negate the proposition that the product may contain aspirin as well (Silver, Tr. 6205–06). [60]

186. Further evidence that Aspercreme packaging information does not overcome impressions that the product contains aspirin is seen in the Schneider (CX 52) and Nicholas (CX 53) focus groups (F. 120–25, *supra*). There, respondents had Aspercreme packages during a trial period of ten days and two weeks. After presumably seeing the package information, a number of them felt that the product contained aspirin (CXs 52, 53; Cohen, Tr. 552; *also see* Cohen, Tr. 552–53; CX 34B).

V. CERTAIN MEDICAL CHARACTERISTICS OF RHEUMATIC DISEASES AND ARTHRITIS AND CONSUMER INJURY WHICH MAY RESULT FROM MISLEADING OR DECEPTIVE ADVERTISEMENTS TARGETED TO ARTHRITICS

A. *Rheumatic Diseases And Arthritis*

187. Rheumatic diseases cause pain and stiffness of the musculoskeletal system (Golden, Tr. 2681–82; CX 268, p. 35,454). The symptoms of the more common rheumatic diseases are joint and muscular aches, pain and stiffness, and joint inflammation (CX 268, p. 35,453).

188. Arthritis is a rheumatic disease which may be defined as inflammation of the joints (Roth Tr. 1526; Ehrlich, Tr. 3991–92; O'Brien, Tr. 3733; Altschuler, Tr. 3014). The term "arthritis" may be broadly used as an umbrella for more than 100 rheumatic conditions involving discomfort around the joints (O'Brien, Tr. 3929–30; Ehrlich, Tr. 3991; CX 268, p. 35,454). Other types of rheumatic diseases involve muscles, tendons, ligaments, or bursae (a small sac of tissue between muscle and joint (Adriani, Tr. 1281–82)) and are referred to as rheumatism (CX 268, p. 35,454). A non-articular rheumatic condition is one which does not involve the joint, while an arthritic condition is one which involves the joint (CX 45M, No. 240).

189. About 90% of all arthritis is either rheumatoid or osteoarthritis (O'Brien, Tr. 3927–30; CX 268, pp. 35,455–57). Osteoarthritis (degenerative joint disease) is a very common disease, especially among the elderly. Rheumatoid arthritis, which occurs in both adults and juveniles, is a systematic disease, but is characterized by inflammation of the synovial joints (movable joints which have a cavity and are lined by a synovium, or joint lining which is a specialized connective tissue) (Adriani, Tr. 1271–72; Ehrlich, Tr. 3992–93; CX 268, p. 35,457). According to the Arthritis Foundation, osteoarthritis afflicts some sixteen million persons, and rheumatoid arthritis, seven million (O'Brien, Tr. 3930). **[61]**

190. It is a misconception to view arthritis as minor aches and pains, a non-lethal disease of old age for which nothing can be done (O'Brien, Tr. 3928–29; CX 268, p. 35,454). Arthritis is a serious public health problem. Arthritis, particularly rheumatoid arthritis, causes lost work time and money. About twenty-seven million work days are lost annually because of arthritis (Roth, Tr. 1536–37; CX 268, p. 35,455). Osteoarthritis is an aging population like ours is an increasing problem in terms of medical costs (Roth, Tr. 1536–37).

191. Many arthritic diseases interfere with a normal life by changing the quality and productivity of life (Roth, Tr. 1537–38). Arthritis and rheumatism are second only to heart disease as a cause of chronic limitation of major activity. About one in every five chronically housebound invalids has arthritis. Although arthritis cripples a large

number of persons each year, it kills relatively few. There is no other group of diseases which causes so much pain and suffering by so many for so long. Because of the tendency to cripple without killing, arthritis and rheumatism head the list of chronic diseases from the standpoint of social and economic importance (CX 268, p. 35,455).

192. The FDA OTC Internal Analgesic Advisory Panel concluded that accepted OTC antirheumatic agents, such as aspirin and other salicylate products, "should be used in the treatment of rheumatic diseases only under the advice and supervision of a physician" for the reason that "basically, each person with symptoms of the more common rheumatic diseases, *e.g.*, joint and muscular aches, pains and stiffness, and joint swelling should seek the advice of a physician for proper diagnosis of the specific cause of the symptoms and for identification of the exact rheumatic disease involved." The Panel concurred with the National Institute of Arthritis, Metabolism and Digestive Diseases ("NIAMD") which advised "If you have arthritis, do not try to treat yourself. All forms of arthritis must be treated by a qualified physician" (CX 268, p. 35,453).

193. More money is spent on unproven remedies and quackery than on arthritis research in the United States because people with arthritis are desperate and looking for cures (Roth, Tr. 1537).

194. Aspercreme is a topical rub promoted by Thompson for use as an analgesic for relief of various types of musculoskeletal pain. The active ingredient in Aspercreme is 10% triethanolamine salicylate (TEA/S). Aspercreme does not contain aspirin (Ans. at 4). Accordingly, the advertising representations that Aspercreme contains aspirin as alleged in Paragraph 10(a) and Paragraph 16 (the use of the brand name Aspercreme) is false. **[62]**

195. Strictly speaking, Aspercreme is not a recently discovered or developed drug product: Aspercreme has been available since 1971 and TEA/S, its active ingredient, has been in existence since at least 1954 (Ans. at 3). Strictly speaking, therefore, the implied representation that Aspercreme is a recently discovered drug is false. However, common sense argues that a relatively obscure product, such as Aspercreme in the late 1970's, should be allowed some leeway during the initial ad campaign in claiming novelty.

B. *Consumers Are Unable To Evaluate The True Pharmacological Effects Of OTC Analgesic Drugs Such As Aspercreme*

196. There is an important difference between a consumer's ability to perceive his pain relief and his ability to evaluate the true pharmacological efficacy of an OTC analgesic drug (Ross, Tr. 6426–29). *See Warner-Lambert Co.,* 86 F.T.C. 1398, 1495 (1975), *aff'd,* 562 F. 2d 749 (D.C. Cir. 1977), *cert. denied,* 435 U.S. 950 (1978).

197. Most arthritis and rheumatism pain is characterized by peaks and valleys and spontaneous remissions and will often subside with the mere passage of time and without treatment (Adriani, Tr. 1271; Altschuler, Tr. 3072–73; Ehrlich, Tr. 4092–93; Golden, Tr. 2905–07; O'Brien, Tr. 3732–33, 3768–69; Silverman, Tr. 2334). Under these circumstances, consumers who use Aspercreme cannot evaluate whether any pain relief they perceived was the result of pharmacologic action of the product or due to mere passage of time (Ross, Tr. 6443–44). Nevertheless, they would attribute the perceived pain relief to Aspercreme (Ross, Tr. 6443–44; *see also*, Ehrlich, Tr. 4225; O'Brien, Tr. 3778).

198. A large number of the users of Aspercreme (and other TEA/S products) use other medications as well (Ehrlich, Tr. 4013, Ross, Tr. 6126; Tr. 2636 (Myoflex recommended for use as an adjuvant). *See* CX 45Z–016–17 (Admission No. 5); Golden, Tr. 2768). These consumers cannot evaluate whether the relief they perceived came from Aspercreme or from the other products they were taking (Ross, Tr. 6442).

199. Consumers are directed to apply Aspercreme by rubbing or massaging it into painful areas until it is well absorbed (*See* RX 282–83; RPX 3–6). Since rubbing alone is well-known to have a soothing effect in treating musculoskeletal pain (Ehrlich, Tr. 4060–61; Golden, Tr. 2768; Heller, Tr. 2622; Roth, Tr. 1630, 1750, 1753–54; CX 269, pp. 69,783–84), consumers are [63] unable to evaluate whether any relief they perceived came from the rubbing or from the pharmacological effect of Aspercreme (Ehrlich, Tr. 4088; Golden, Tr. 2768; Ross, Tr. 6442).

200. Placebo response refers to the relief perceived from a pharmacologically inert agent (placebo), and, therefore, not attributable to the agent's pharmacological effect (Altschuler, Tr. 3096; Ehrlich, Tr. 4107; Roth, Tr. 1549; CX 268, p. 35,444). Placebo response is a commonly observed phenomenon, particularly in situations involving analgesia (pain relief) (CX 268, p. 35,444). This is because the subjective nature of pain makes it particularly amenable to suggestion (Ehrlich, Tr. 4092, 4150–51). A drug must provide significantly greater relief than a placebo to be considered effective (Ehrlich, Tr. 4153–54; Roth, Tr. 1629; CX 268, p. 35,444).

201. The placebo response rate averages around 35% (Ehrlich, Tr. 4095–97, 4116–17; O'Brien, Tr. 3790), and may range as high as 60% (O'Brien, Tr. 3773; Roth, Tr. 1550). Placebo response has been extensively investigated by experts in the field of analgesics (O'Brien, Tr. 3790). In a frequently cited 1955 survey article, entitled "The Powerful Placebo," Dr. H. K. Beecher reported that placebos were highly effective, having produced an average response rate of 35.2% in over 1,000 patients in fifteen different clinical studies encompassing a wide

variety of conditions, including post-operative pain, headache pain, angina pain, nausea, cough, anxiety and tension, and the common cold (Ehrlich, Tr. 4095–97, 4116–17; O'Brien, Tr. 3790). The placebo effect is substantial in the case of arthritis (Silverman, Tr. 2337). For example, a published study on rheumatoid arthritis reported a placebo response rate of 50% to placebo pills (Ehrlich, Tr. 4127–29).

202. The placebo response is not just a short-term phenomenon. In the case of arthritis, placebo relief can last for as long as twenty to thirty months (Ehrlich, Tr. 4127–29; O'Brien, Tr. 3774–75). In a study of the placebo response in patients with rheumatoid arthritis, 31% of the patients experienced relief for a period ranging from two to twenty months (Ehrlich, Tr. 4127–29).

203. Consumer expectations also have a significant impact on the perceived performance of a product. Perceptions of performance are heavily influenced by expectations, and these expectations can carry through to consumers' evaluation of the product's performance. In other words, the higher the expectation of performance is, the higher will be the perception of performance (Ross, Tr. 6430–31, 6433). Studies have shown that, despite the fact that one cake was preferred in a blinded test as more moist, labeling the other cake as the preferred brand for moistness can lead consumers to perceive that the **[64]** other brand was more moist (Ross, Tr. 6431). Similarly, in a drug study where a placebo was given to two groups, one of which was told it was an energizer and the other told it was a tranquilizer, both groups responded in accordance with what they were told (Ehrlich, Tr. 4151–52).

204. Advertising can play a major role in creating expectations of relief for an analgesic product (Ross, Tr. 6435). And the impact of advertising is particularly significant on arthritics (Roth, Tr. 1539–40). Aspercreme's advertising created consumer expectations that the product would provide relief (Adriani, Tr. 1238; Ross, Tr. 6435; Roth, Tr. 1615–17). Hence, most Aspercreme purchasers buy the product with the expectation of relief (Ross, Tr. 6435). Thus, Aspercreme advertising may have significantly increased the placebo effect on Aspercreme users (Adriani, Tr. 1238; Roth, Tr. 1615–17).

205. The perception that a treatment is new results in enthusiasm and heightened expectations (Ehrlich, Tr. 4109; O'Brien, Tr. 3770–72, 3775–76; Roth, Tr. 1540). This, in turn, can lead to an exaggerated perception of the treatment's effectiveness (Ehrlich, Tr. 4109; O'Brien, Tr. 3770–72, 3775–76). Hence, the well-known comment that "we must use new drugs quickly before they lose their power to heal" (O'Brien, Tr. 3775–76; *see also,* Ehrlich, Tr. 4109; O'Brien, Tr. 3770–72). To the extent the ads claimed Aspercreme to be a newly developed

drug, consumers' expectations and perceptions of its value may well have been enhanced.

206. The effect of expectations on perceived product performance can be negated if expectations are discomfirmed by experience with the product (Ross, Tr. 6430–31, 6446–47). However, because of the self-limiting nature of rheumatic pain, the placebo response, the effect of concomitant medications, and the rubbing effect, consumers cannot accurately evaluate the true efficacy of Aspercreme (F. 197–99, *supra*). Under these circumstances, there is in fact no opportunity for usage to disconfirm consumer expectations, and each time consumers use Aspercreme they are reinforcing expectations they had when they came to the product in the first place (Ross, Tr. 6446–47).

C. *The Use Of An Unproven OTC Remedy May Cause Significant Physical And Economic Harm To Consumers Who Suffer From Rheumatic Diseases Including Arthritis*

207. The use of an OTC drug product, which is not significantly different from placebo, for self-medication to **[65]** treat rheumatic pain poses a real danger to the consumer (O'Brien, Tr. 3722; Roth, Tr. 1538–39). As indicated by Dr. Altschuler, a physician called as an expert by Thompson, in treating patients with rheumatic pain it is appropriate to address the underlying problem directly, rather than using a placebo for pain relief (Altschuler, Tr. 3043–44; *see* F. 190–92, *supra*). It is not true for patients with rheumatic pain that a placebo is helpful and safe to apply (Altschuler, Tr. 3093). A person with a disease (such as rheumatic disease) should not take an inert substance as therapy (O'Brien, Tr. 3935).

208. The failure to promptly diagnose and treat rheumatic diseases with effective medication can have serious effects upon the individual. Not all musculoskeletal pain is the same (Roth, Tr. 1767; CX 268, p. 35,454). The pain due to overexertion is different from the persistent, although not severe, pain of early rheumatoid arthritis, where the harm of not seeking timely evaluation and treatment is great (*Id.*). In some instances, relatively minor pain can be the first warning of very serious conditions (Roth, Tr. 1636).

209. There is significant harm to consumers when patients in early stages of a rheumatic disease use Aspercreme for minor pain and fail to seek effective therapy (Roth, Tr. 1615–17). Moreover, because of the consumer's inability to evaluate the true efficacy of OTC analgesic drugs, such usage may continue over a long period of time. If not diagnosed and treated properly and at an early stage, rheumatic diseases can lead to progressive degeneration and debilitation (CX 268, pp. 35,454-56). And although the pain associated with rheumatic diseases can sometimes be relieved by antirheumatic OTC analgesics,

the more serious underlying features of the disease, which often lead to progressive degeneration and the prospect of permanent physical disability, may go untreated (*Id.*). Thus, Thompson's own expert, Dr. O'Brien, agreed that it would be inappropriate for an arthritic to self-medicate with a product which in fact is not significantly better than placebo because he or she may thus substitute an ineffective and unproven remedy for a truly effective drug (O'Brien, Tr. 3722).

210. In terms of economic costs, a therapeutically inactive medication, no matter how inexpensive, is a costly drug to the consumer (Silverman, Tr. 2440–41), and to society as well. Not only is the consumer wasting his money (Roth, Tr. 1538–39) by the initial purchase, but because of his inability to evaluate drug efficacy the consumer can also be expected to make repeat purchases of the product. In the aggregate, expenditures for such products represent a waste of societal resources. There is more money spent on unproven remedies and quackery than arthritis research in the United States because people with [66] arthritis are desperate and looking for cures (Roth, Tr. 1536–37). Indeed, Ogilvy and Mather International, Inc., Thompson's ad agency which created the challenged Aspercreme advertising, has pointed to a $400 million industry in fraudulent arthritis remedies (CX 54C). The Arthritis Foundation has expressed its concern about ineffective remedies that burden society with their cost (O'Brien, Tr. 3952). The failure to treat rheumatic diseases with effective drugs can lead to lost work time and money by disease victims (Roth, Tr. 1536–37). Additionally, there is the problem of evolving medical costs where the disease progresses unchecked (*Id.*). For these reasons, an unproven remedy such as Aspercreme can cause significant economic harm to the consumer and to society as a whole.

D. *Costs And Benefits Of Requiring Thompson To Have A Reasonable Basis Of Support For Its Advertising Claims For Aspercreme*

211. For the reasons discussed herein above, there are substantial benefits to both individual consumers and society as a whole in requiring Thompson to have a scientifically acceptable and legally sufficient substantiation for its efficacy claims for Aspercreme. Although a pain study is not among the simplest, the costs to Thompson associated with such a requirement are relatively modest. Expert opinion in this case placed the cost of conducting a well-controlled clinical trial to demonstrate analgesic efficacy in the range of $10,000 - $15,000 per test (Adriani, Tr. 1175–76; Roth, Tr. 1562). Because one ideal study that would not require replication might well be more expensive than two acceptable clinical tests, requiring two adequate tests may be

more practical, even viewed from a purely economic standpoint (Roth, Tr. 1562–63).

212. It is apparent that the requirement for clinical trials is not burdensome when one considers the modest cost of conducting clinical testing in light of the costs associated with the marketing and advertising of an unproven drug product. In any event, on the basis of this record, imposition of the relatively modest cost of two clinicals cannot be reasonably expected to have a significant adverse effect on a manufacturer's plans to bring such an OTC analgesic drug product to the market.

213. For all of the foregoing reasons, the benefits of requiring Thompson to possess and rely upon the acceptable level of scientific substantiation for its Aspercreme efficacy claims clearly outweigh the costs involved in meeting that requirement. [67]

VI. ADEQUATE SUBSTANTIATION OF OTC ANALGESIC DRUG EFFICACY REQUIRES WELL-CONTROLLED CLINICAL TRIALS

A. *It Is Well Settled That Adequate And Well-Controlled Clinical Trials Are Required To Show The Effectiveness Of Drugs, Including OTC Analgesic Drugs*

214. It is well settled that well-controlled clinical trials are required to establish analgesic efficacy of a drug (Adriani, Tr. 1156; Roth, Tr. 1541–42; 46 FR 47,731 (1979)). *Also see, American Home Product Corp.*, 98 F.T.C. 136, 201, 376–81 (1981), *modified*, 696 F. 2d 681 (3rd Cir. 1983). [101 F.T.C. 698 (1983)]

215. The 1962 amendments to the Food, Drug and Cosmetic Act explicitly incorporated the requirement of "adequate and well-controlled" "clinical investigations" for drug efficacy in general. 21 U.S.C. 355(d) (1976). The FDA regulations promulgated to implement the 1962 amendments set forth the essential elements of adequate and well-controlled clinicals. 21 C.F.R. 314.111(a)(5)(ii) (1982). The FDA has also determined that the 1962 Act's requirement for "clinical investigations" means that at least two adequate and well-controlled clinicals are required. 44 FR 51,512, 51,518 (1979).

216. The FDA's 1972 OTC drug review procedure provided by regulation that the same level of clinical evidence to show the effectiveness of a new drug be required to document the efficacy of an OTC drug on the market "unless this requirement is waived on the basis of a showing that it is not reasonably applicable to the drug or essential to the value of the investigation." 21 C.F.R. 330.10(a)(4)(ii) (1982). In this connection, the FDA has expressly rejected the contention that the standards for new drug approval are inappropriate for OTC drugs that have been on the market for a substantial period of time and

noted that they represent "what medical scientists today consider to be adequate proof of effectiveness." *See* FDA OTC Drug Review Policy Statement; 46 FR 47,729, 47,731 (1979).

217. The FDA's OTC Internal Analgesic Panel and OTC External Analgesic Panel have adopted similar requirements for adequate and well-controlled clinicals to show efficacy for OTC analgesic drugs (CX 268, pp. 35,444–45, CX 269, pp. 69,857–58).

218. Other corroborative evidence, such as long-term use of a drug in the market and reports of clinical experience with a drug is not an acceptable substitute for well-controlled [68] clinicals to show drug efficacy (Adriani, Tr. 1439–40; Roth, Tr. 1765–66; 46 FR 47,731 (1979)).

219. Thompson does not seriously dispute the general requirement that adequate and well-controlled clinicals are needed to establish drug efficacy. However, it has maintained that in the case of a mild and harmless topical analgesic drug (such as Aspercreme) that requirement should be greatly relaxed or dispensed with (Ehrlich, Tr. 4085–86; O'Brien, Tr. 3968–72; Steinberg, Tr. 5205–07, 5218–19). This position is contrary to the prevailing and accepted view of the medical scientific community and has been rejected by the FDA (F. 216, *supra*).

220. There is no adequate substitute for clinical trials to demonstrate the efficacy of a drug for pain relief. The FDA panels on internal and external analgesics both noted that pain is a subjective experience (CX 268, p. 35,444, CX 269, p. 69,857). When a clinical trial involves subjective reports such as pain, the elements of a well-controlled clinical trial are crucial. Hence, the efficacy of an analgesic drug cannot be shown simply by producing a number of positive studies if they are not adequate and well-controlled studies (O'Brien, Tr. 3784–85).

221. The FDA Internal Analgesic Panel and External Analgesic Panel also explicitly rejected animal screening tests, experimental pain, bioavailability studies, and other artificial measures as substitutes for clinical trials to show drug efficacy (CX 268, p. 35,444, CX 269, p. 69,857). Both panels concluded that efficacy of analgesic drugs must be appraised by accepting the subjects' own reports on indices of pain experiences (CX 268, p. 35,444, CX 269, p. 69,857).

222. The medical scientific community requires replication of the results of a clinical test involving an analgesic drug (Adriani, Tr. 1438; O'Brien, Tr. 3796–97; Roth, Tr. 1541). The FDA panels on internal and external analgesics both require a minimum of two positive well-controlled trials by different investigators or laboratories to demonstrate the effectiveness of an analgesic drug (CX 268, p. 35,445, CX 269, 69,858). Replication is necessary because there is a potential for systematic bias and random error in any clinical trial: the methodolo-

gy may be insensitive, or the wrong conclusion may be reached by sheer chance (O'Brien, Tr. 3798). Moreover, even an experienced investigator may use an aberrant methodology, or some unexpected flaw or anomaly in the randomized population may bias the test results (Roth, Tr. 1561). Other possible sources of systematic bias include the geographic location of the trial and idiosyncracies in the way the data are collected (Adriani, Tr. 1174, 1333). **[69]**

B. *Elements Of A Well-Controlled Clinical Trial*

223. Over a period of years, a number of standards for an adequate and well-controlled clinical trial have been developed by the medical scientific community. In regulation promulgated under the 1962 amendments to the Food, Drug and Cosmetic Act, the FDA has codified these standards. 21 C.F.R. 314.111(a)(5)(ii) (1982). The FDA has expressly adopted these same standards for proof of effectiveness of OTC drugs. 21 C.F.R. 330.10(a)(4)(ii) (1982). The record shows that the standards set forth in these FDA regulations are those accepted by the medical/scientific community as a whole (Adriani, Tr. 1158; Ehrlich, Tr. 4066–67; O'Brien, Tr. 3745; Roth, Tr. 1541–42). The reports of the FDA panels on internal (CX 268) and external analgesics (CX 269) also reflect the testing standards the medical/scientific community would apply in the case of analgesic drugs (Adriani, Tr. 1159).

224. The standards commonly used to evaluate the adequacy of a clinical trial for establishing the efficacy of a drug include: (1) a written protocol or plan for the study; (2) a suitable control; (3) adequate blinding of subjects and investigators to minimize bias; (4) randomization of treatments; (5) qualified investigators; (6) an appropriate patient population; and (7) appropriate statistical methods to evaluate the results (*E.g.*, CX 269, pp. 69,857–58).

225. A written protocol which defines the study's objectives and methods is a critical element of a well-controlled trial (Adriani, Tr. 1167; Ehrlich, Tr. 4067–68; O'Brien, Tr. 3754–55; Roth, Tr. 1551). The protocol should be written before the study is conducted (Adriani, Tr. 1167–68; CX 451 (Admission No. 147)). It should describe the essential elements of the study design as well as the analysis plan, including the scoring system to be used in evaluating the results (Adriani, Tr. 1169, 1199–200; Roth, Tr. 1551–52, 1555–56, 1591–92; CX 269, p. 69,-858). Departures from the protocol should be minimized to insure the validity of the ultimate analysis (Ehrlich, Tr. 4067–68; O'Brien, Tr. 3754–55). Any major change or amendment to the protocol should be in writing (Adriani, Tr. 1169; O'Brien, Tr. 3753–55; Roth, Tr. 1551). Data for a subject who breaches the protocol in a meaningful manner, by not taking the drug as directed or by otherwise acting inconsistently with the protocol's directions, should be discarded (Ehrlich, Tr.

4067–68; O'Brien, Tr. 3759–60). Including the analysis plan in the protocol is essential to protect the integrity of the study (Adriani, Tr. 1199–200; Roth, Tr. 1591–92). Selecting the statistical analysis and scoring system in advance guards against conscious or unconscious bias on the part of the investigator. [70]

226. In order to minimize bias, a well-controlled clinical trial should incorporate at least one of four types of controls that are generally recognized as providing a comparison of treatments in a way that permits quantitative evaluation of the results. A study may incorporate a placebo control that compares the result of a test drug with an inert substance designed to resemble the test drug. When objective measurements of effectiveness are available and the placebo effect is negligible, comparison of treated and untreated subjects may be appropriate. In circumstances involving diseases with high and predictable mortality and uniform symptoms, an historical control may be used, whereby the results of a new treatment are compared with case histories in similar patient populations. An active treatment control (use of an effective therapy for comparison) may be appropriate in some circumstances, such as a condition where withholding treatment of administering a placebo would be against the interest of the patient. 21 C.F.R. 314.111(a)(5)(ii)(a)(4) (1982).

227. In an analgesic trial, it is not appropriate to use "no treatment" as a control. Pain is a subjective sensation (Adriani, Tr. 1160–61; CX 269, p. 69,857). And the placebo effect is known to be substantial. Also, the use of an historical control is not appropriate because there is no reason not to use a current control (O'Brien, Tr. 3750–51). Moreover, since all pain is subjective and musculoskeletal pain fluctuates, use of an historical control for a drug like TEA/S is inappropriate.

228. A placebo control is commonly required for a clinical trial of an analgesic drug in order to provide a consistent variable to determine whether a drug has a pharmacological effect (Adriani, Tr. 1423–24; Roth, Tr. 1549). A placebo control is particularly important in a study involving a drug for relief of pain because administration of a placebo produces a response that resembles the response to a mild analgesic (Adriani, Tr. 1164–65; Roth Tr. 1550; CX 45J (Admission No. 165), CX 268, p. 35,444). Establishing the sensitivity of the methodology used is important in the case of a clinical trial of a mild analgesic (Adriani, Tr. 1441–44; O'Brien, Tr. 3801–02; CX 268, p. 35,445). Accordingly, a clinical trial comparing a known analgesic to a test drug should incorporate a placebo control if the effectiveness of the test drug has not been established (Adriani, Tr. 1441–44; Roth, Tr. 1563–65). Especially in the case of rheumatoid arthritis and osteoarthritis, an uncontrolled trial is not reliable because the placebo effect may account for the good results (O'Brien, Tr. 3926–27). [71]

229. An analgesic trial should be double-blinded (CX 268, p. 35,444, CX 269, p. 69,857). An effective double-blind is critical in analgesic studies because they record patient's subjective responses. Effective blinding requires that neither the bottles, the physical characteristics of the test substance (such as taste and smell), nor the data sheets give any clue as to the identity of the substances used in the trial (Roth, Tr. 1548). Blinding both the subjects and the investigators is required to minimize bias (Adriani, Tr. 1162–63; Golden, Tr. 2959; O'Brien, Tr. 3782–83; Silverman, Tr. 2404). Single-blind studies are not acceptable for mild to moderate analgesics (Adriani, Tr. 1422). 21 C.F.R. 314.111(a)(5)(ii)(c) (1982).

230. In a well-controlled clinical trial, test subjects should be assigned to treatment groups in a manner that reduces bias, yet seeks to assure comparability of the test and control groups in terms of relevant variables such as sex, age, severity of condition, and the like. 21 C.F.R. 314.111(a)(5)(ii)(2) (1982). Therefore, an appropriate randomization procedure should be used so that these variables balance out (Adriani, Tr. 1165–66; Roth, Tr. 1543–44; CX 268, p. 35,444, CX 269, p. 69,857).

231. A clinical trial should be conducted by an experienced investigator with an appropriate background in the disease being evaluated (Roth, Tr. 1558; Silverman, Tr. 2311). The personnel who administer the test should also be experienced, as well as properly trained and instructed in using the measures involved in the clinical trial (Adriani, Tr. 1172; Roth, Tr. 1558–59).

232. In an analgesic trial of a drug intended for relief of various types of pain, a sufficient number of subjects with each of the appropriate types of pain should be studied (Silverman, Tr. 2311; CX 269, p. 69,857). The number of subjects should be sufficient to permit statistical analysis of the data, eliminate bias, and take the placebo effect into account. The subjects should be of both sexes and should be within the age range that would use the test drug (CX 269, p. 69,857). For clinical studies of OTC analgesics, each treatment group should contain between thirty and sixty subjects. *See American Home Products Corp.*, 98 F.T.C. at 202–03.

233. For a test of an antirheumatic drug, patients with suitable inflammatory rheumatic diseases should be selected (Adriani, Tr. 1159–60; CX 268, p. 35,468). Subjects should be grouped and studied by disease category (CX 268, p. 35,468).

234. An analysis of the results of a clinical trial is usually reported in terms of statistical significance so that the degree of confidence in the results can be assessed. In biomedical trials, 95% confidence level (or P value not greater [72] than of 0.05) is the accepted standard for statistical significance (Adriani, Tr. 1170; Ehrlich, Tr. 4068–69; Freu-

denthal, Tr. 4983; Roth, Tr. 1556–57; Silverman, Tr. 2317; CX 45Y (Admission No. 148)). In a clinical trial to determine whether treatments are significantly different from each other, a finding of statistical significance at the 95% confidence level means that there is a chance of only one in twenty that the difference observed may be due to chance alone.

235. When the results of a clinical trial have been determined to be statistically significant, the next question is whether the results are also clinically important. Statistically significant results may be clinically so small that the choice between two treatments may lack therapeutic significance (Adriani, Tr. 1171; Roth, Tr. 1557). Accordingly, statistically significant differences can be clinically insignificant.

236. For observed differences between treatments to be clinically significant, the differences must be real. A finding of statistical significance verifies that the observed differences are in fact real (Ehrlich, Tr. 4080–82). Thus, to be clinically significant, the observed differences between two treatments must be statistically significant in order to rule out the possibility that the differences are due to chance alone (Adriani, Tr. 1171–72; Roth, Tr. 1557–58).

237. In a comparative drug trial, the hypothesis being tested is that there is no difference between the two drugs (Freudenthal, Tr. 5007). Since it is not possible to prove a null hypothesis, one can only measure the differences between two treatments and assess whether or not the data are inconsistent with the null hypothesis (Ehrlich, Tr. 4169–70; Freudenthal 5008–09). A danger in evaluating clinical trials is to misinterpret a failure to demonstrate a difference between two treatments as meaning that the treatments are in fact the same. When differences are statistically significant, the results can be said to be due to essential differences in the drugs. When differences are statistically insignificant, however, this does not rule out the possibility that real differences may not exist (Ehrlich, Tr. 4170–72; Freudenthal, Tr. 5009–12; O'Brien, Tr. 3800).

238. Although pain relief cannot be ojbectively measured, there are appropriate objective measures of inflammation that can be used in a trial of an antirheumatic drug. These measures include grip strength, flexion, ring size, and walking time (Adriani, Tr. 1476; Ehrlich, Tr. 4017–18; Roth, Tr. 1545–47). Objective measures are useful in a clinical trial because multiple measurements can corroborate one another (O'Brien, Tr. 3781–82; Roth, Tr. 1553). Moreover, a subject's global [73] evaluation of the level of his pain may be difficult to interpret (Roth, Tr. 1668). Accordingly, a clinical trial incorporating objective measures, where possible, is preferable to a study based exclusively on subjective judgments (Silverman, Tr. 2402, 2411–13; CX 396F, J). For example, Dr. Ehrlich, respondent's witness, has

incorporated objective measures in clinical trials he conducted (Ehrlich, Tr. 4017–18).

239. In a clinical trial, the use of the test drug should conform to reality. The test subjects should use the drug in the same manner as a consumer would in terms of dosage level, method of application, and the like (Adriani, Tr. 1170; Roth, Tr. 1552; Silverman, Tr. 2312). Accordingly, patient subjects should be instructed to use the product correctly. Insuring that the subjects follow instructions is also important (Silverman, Tr. 2312). For example, oral instructions may be reinforced in writing; pill counts may confirm that subjects followed instructions; and urine and blood tests may demonstrate that the subjects actually used the medications (Roth, Tr. 1559–61).

240. The record is clear that the FDA requires, for OTC drug labeling purposes, two or more well-controlled clinical trials to show efficacy. In particular, the FDA OTC External Analgesic Panel and the FDA's Tentative Final Monograph on OTC Analgesic Products have applied the "well-controlled clinicals" rule to TEA/S and concluded that there was insufficient evidence to show TEA/S analgesic efficacy (F. 393–95, *infra*).

241. The obvious need for regulatory harmony and uniform standards governing the issue of OTC drug efficacy dictates that the same level of scientific evidence required by the FDA for OTC drug labeling/marketing be demanded by the FTC for OTC drug advertising with respect to the issue of efficacy.

242. The need to require adequate scientific evidence of efficacy is greater in cases where, as here, a relatively obscure topical product is being touted as a proven effective pain reliever for arthritis sufferers, a group singularly disposed to grasp at new promises of relief (F. 193, *supra*).

VII. THE CLINICAL TRIALS AND OTHER MATERIAL AND INFORMATION IN EVIDENCE FALL SHORT OF AN ADEQUATE SUBSTANTIATION FOR THE EFFICACY CLAIMS CONTAINED IN ASPERCREME ADVERTISEMENTS

243. The clinical trials Thompson relies on in this proceeding as evidence of efficacy are deficient in several important respects and none of them can appropriately be relied [74] on as an adequate and well-controlled trial which shows Aspercreme's effectiveness as an analgesic drug.

244. The most that can be said for Aspercreme is that it is being promoted as a topical analgesic for relief of mild pain and, *if shown to be effective,* can offer a topical alternative to OTC internal analgesic products, many of which are known to have significant adverse side effects especially at high arthritic dose levels. The record evidence clearly shows that the analgesic efficacy of Aspercreme remains to be

shown, although there is a modicum of evidence of some skin-penetration of salicylate molecules (bioavailability) (*See* F. 315–25, *infra*). Until the analgesic efficacy of TEA/S is established, however, much more than evidence of *bioavailability* is required. What is required is adequate evidence of *bioactivity*. This was precisely the reason why the FDA's External Analgesics Panel (CX 269) and the FDA's proposed rule governing OTC external analgesic products (CX 443 - Tentative Final Monograph dated February 8, 1982) both concluded that there is yet insufficient evidence to show the analgesic efficacy of TEA/S for labeling purposes under the Food, Drug and Cosmetic Act.

245. The clinical trials relied on by Thompson include the following purportedly well-controlled trials: the Golden study (RX 49/CX 200); the Golden-Altschuler study (RX 50/CX 214); and the so-called French studies by Drs. Patel and Chappelle (RX 34/CX 209; RX 35/CX 208; RX 36/CX 210; RX 37/CX 253 and RX 38/CX 266). *See* RB 39–49.

A. *The Golden Study (RX 49/CX 200)*

246. In 1976, Thompson asked Dr. Robert Marlin, its consultant, to design and set up a clinical study for Aspercreme (Marlin, Tr. 3183–85). Dr. Marlin knew that Dr. Golden was a board-certified rheumatologist and that Dr. Golden possessed the proper credentials to conduct the study (Steinberg, Tr. 5149–50).

247. Dr. Golden first did a pilot study to test the reaction of five patients to this product. He then wrote to Dr. Steinberg of Thompson and reported his preliminary finding that the product worked very well on patients with nonarticular rheumatic problems, that four out of the five patients experienced pain relief, but the fifth, who had severe osteoarthritis of the knee, was not helped (RX 47). Dr. Golden was encouraged by the results of the pilot study and agreed to conduct a full-fledged controlled clinical study (Golden, Tr. 2684–85; Steinberg, Tr. 5150–51). [75]

248. Dr. Marlin conferred with Dr. Golden and drafted a protocol for the study, with twenty patients in each group for a total of forty patients. In the opinion of Drs. Marlin and Golden, forty patients was a significant number of subjects from which to derive meaningful data (Golden, Tr. 2687–89; Marlin, Tr. 3183, 3186–87, 3452). Dr. Marlin recommended that Aspercreme be tested against aspirin because aspirin is known as the comparison drug in tests of nonsteroidal inflammatory drugs (Marlin, Tr. 3188, 3452). The study was set up as a double-blind trial with two groups of twenty patients, each group approximately equal in distribution of age, sex, and types of rheumatic pain (Golden, Tr. 2691).

249. In his capacity as coordinator and monitor, Dr. Marlin took

care of getting the test drug, the aspirin, and the placebo products from the manufacturer to Dr. Roslyn Freudenthal, a biostatistician. Dr. Freudenthal packaged the aspirin, placebo, and test medication in boxes that were unmarked except for a code number (Freudenthal, Tr. 4899). When Dr. Freudenthal had completed randomizing the medication to eliminate any possibility of bias, Dr. Marlin arranged for the medication to be sent to Dr. Golden's office (Marlin, Tr. 3209; Steinberg, Tr. 5151–52). The subjects in the study were primarily drawn from a pool of Dr. Golden's regular patients. After Dr. Golden had determined that the subject was acceptable under the study's protocol, the patient was given tablets and cream and instructed in the use of the medication (Golden, Tr. 2693). Dr. Marlin monitored the study by visiting Dr. Golden approximately once every week to ensure that the protocol was being followed. At that time, he also reviewed the case report forms with Dr. Golden (Marlin, Tr. 3124–25). It was Dr. Golden who collected the raw data (Golden, Tr. 2687–88). Dr. Marlin reviewed the data and forwarded the data to the biostatistician, who broke the code and analyzed the results (Golden, Tr. 2696).

250. The Golden study compared the pain relief achieved by the two groups; one group took aspirin tablets and rubbed a placebo cream into the painful area four times a day, the other group ingested a placebo and rubbed Aspercreme into the painful area four times a day (Golden, Tr. 2687–88). Dr. Freudenthal set up the code in such a manner that the study was completely blind. No one except Dr. Freudenthal had access to the code (Freudenthal, Tr. 4899–901). After the study was completed, Dr. Freudenthal conducted her analysis, wrote her report, and sent her report to Thompson (Freudenthal, Tr. 4904–08; RX 83).

251. Dr. Freudenthal's statistical analysis of the data showed that the group receiving the placebo tablets and Aspercreme rub did as well as and sometimes better than the group receiving aspirin tablets and the placebo rub (RX 82). There was a statistically significant greater number of patients **[76]** in the aspirin group that experienced adverse reactions. The report also showed a somewhat faster pain relief for the Aspercreme group (Freudenthal, Tr. 4908–09; Golden, Tr. 2698–700; Marlin, Tr. 3223–24; Steinberg, Tr. 5155–56; RX 49). The Golden Study was the test (or controlled test) referred to in CXs 7 and 8, print ads for Aspercreme. Dr. Marlin analyzed the data and reached conclusions similar to those of Dr. Freudenthal (Marlin, Tr. 3224, 3226).

252. The Golden study, however, failed to show a statistically significant difference between the experience of the aspirin and Aspercreme groups in terms of pain relief (Erhlich, Tr. 4165–66; Freudenthal, Tr. 5015–16; Steinberg, Tr. 5252–53; RX 83F–G). Also,

the Golden study does not show that Aspercreme is *more* effective than aspirin for pain relief (O'Brien, Tr. 3792). Nor did the Golden study measure or show that Aspercreme is effective as an anti-inflammatory drug (Ehrlich, Tr. 4164–65; O'Brien, Tr. 3793–94).

253. A failure to demonstrate statistically significant differences between drugs, however, does not mean that there are no real differences between them (F. 237, *supra*). It is not unusual for a clinical study to fail to distinguish between aspirin, a known active drug, and placebo. Thus, in a single clinical trial, the failure to show a difference between the two tested drugs does not mean that the two drugs are equally effective (O'Brien, Tr. 3798). Errors can occur; the methodology can be insensitive; or the wrong conclusion may be reached by sheer chance (*see* Ehrlich, Tr. 4188–89; Freudenthal, Tr. 4890–91, 4897–98).

254. In clinical trials of mild analgesics, it is important to insure the sensitivity of the test methodology (O'Brien, Tr. 3101–02). A comparison of two drugs, one known to be effective, is termed a positive control (Roth, Tr. 1563–65). If efficacy has not yet been established for the second drug, a placebo must be incorporated into the study design in order to demonstrate the sensitivity of the study's methodology (*Id.*). The Golden study tested Aspercreme against an active control (aspirin), but it did not employ a third group using only placebo pills and placebo cream, and thus was not placebo-controlled (Ehrlich, Tr. 4185; Freudenthal, Tr. 5013–14; Steinberg, Tr. 5252–53; *also see*, F. 228, *supra*). Since there was no placebo control, there is no way to evaluate whether the methodology of this study was sufficiently sensitive to pick up even the known difference between aspirin and a placebo (Ehrlich, Tr. 4187; Freudenthal, Tr. 5014). Accordingly, there is no way to determine whether the study failed to show a difference between aspirin and Aspercreme because no real difference exists or because the methodology used was not sensitive enough to show a difference between the [77] two (Ehrlich, Tr. 4178–79). For this reason, the Golden study's failure to distinguish between Aspercreme and aspirin cannot be considered meaningful in evaluating Aspercreme's analgesic efficacy.

255. Another reason for limiting the import of the Golden study is the truism that a clinical study which fails to show a difference between two drugs does not prove the null hypothesis (*see* F. 234, 237, *supra*). A test of statistical significance at the 95% confidence level enables us to determine whether or not we can reject the null hypothesis (Freudenthal, Tr. 5008). The null hypothesis can be disproven or rejected, but it cannot be proven that the null hypothesis is true (Frudenthal, Tr. 5008–09). Thus, a study which fails to show a statistically significant difference and fails to reject the null

hypothesis does not prove that the two drugs are equal (Freudenthal, Tr. 5012; *see* Freudenthal, Tr. 5009–12). Hence, the Golden study does not show that aspirin and Aspercreme are equally effective.

256. In her addendum to the Golden study (RX 83H), Dr. Freudenthal purported to calculate the type 2 (or beta) error—that is, the likelihood that aspirin is better than Aspercreme—and concluded it was less than .05 (Freudenthal, Tr. 4912–14, 5016–17, 5019–20). However, in calculating the beta error, Dr. Freudenthal did not use the formula that the power of a test is one minus the beta error (Freudenthal, Tr. 5017). Yet, this is the formula set forth by Dr. Mainland, the recognized statistical expert whose word Dr. Freudenthal accepts as authoritative (Freudenthal, Tr. 5008, 5017–19). Dr. Freudenthal's approach to beta error thus differs from Dr. Mainland's (*Id.*). Also, Dr. Freudenthal's results and conclusions are inconsistent with those found in an article by another well-recognized expert, Dr. Freireich (*see* Freudenthal, Tr. 5020–23). In calculating beta error, Dr. Freudenthal did not use any tables referring to the power of a test or to beta error; rather, she referred to tables of confidence intervals (Freudenthal, Tr. 5025–26). Yet, she did not know whether confidence intervals were used to evaluate alpha (type 1) error, rather than beta (type 2) error (Freudenthal, Tr. 5026–27). In later testimony, she defined confidence levels in terms of the likelihood of accepting a chance difference as real (*i.e.*, a type 1, or alpha error) (Freudenthal, Tr. 5033–34). Finally, Dr. Freudenthal did not know whether or not the method she used was the accepted method for calculating beta error (Freudenthal, Tr. 5025). Under these circumstances and for the foregoing reasons, Dr. Freudenthal's calculation of beta error and conclusions based thereon must be rejected as unreliable.

257. The failure of the Golden study to show a difference between aspirin and Aspercreme in terms of pain relief is [78] not surprising in view of its small sample size (twenty in each group). One indication of the consequences of inadequate sample size in the Golden study is that subjects with moderate osteoarthritis who were randomly assigned to the aspirin pills/placebo cream group did not experience pain relief (CX 200D). This result is clearly at variance with other studies of aspirin (Roth, Tr. 1582–83), and would tend to support the conclusion that the Golden study methodology was insensitive. This result may also be attributable in part to the small number of subjects in the study (Roth, Tr. 1767–68).

258. As acknowledged by respondent's own witnesses, and by authorities whose competence and views they acknowledged and respect, the smaller the number of subjects in a study, the more likely it is that the results will show no statistically significant differences between the drugs being tested (Ehrlich, Tr. 4220–22; Freudenthal,

Tr. 5013). As expounded by Dr. Emil Freireich, a recognized authority on the evaluation of clinical trials (Ehrlich, Tr. 4180–81; Marlin, Tr. 3418), comparative studies with small numbers of patients (*i.e.*, twenty-five patients or less in the active treatment group, and the same in the control group) will nearly always produce results showing no significant difference between the two groups (RX 383L). Indeed, Dr. Freireich termed comparative studies using twenty-five subjects or less in each treatment group as "pernicious" (*Id.*). Dr. Marlin conceded that in the Golden study (CX 200), all of the calculations involved sample sizes of twenty or less for each test group (Marlin, Tr. 3419–20).

259. The FDA's Internal Analgesic Panel and External Analgesic Panel recommended sample sizes of at least twenty-five in each group (active treatment and control groups) (Marlin, Tr. 3469–70; CX 268, pp. 35,444–45, CX 269, p. 69,862). In another FTC analgesic proceeding, experts agreed that a sample size of between thirty and sixty in each treatment group was appropriate in analgesic trials (F. 232, *supra*).

260. Dr. Marlin agreed that in analgesic studies (which employ subjective response methodology) one generally needs larger numbers of subjects in order to produce results showing a statistically significant difference between the test group and the control group. The reason is that when one is dealing with subjective responses, the variability is great. In contrast, in studies employing an objective rating methodology, a smaller number of subjects will suffice (Marlin, Tr. 3279–80).

261. The problem of small sample size in the Golden study was exacerbated by the fact that, as reflected in the published report (CX 200), the study data was broken down, after the study was completed, into a large number of smaller subgroups. As [79] explained by Dr. Roth, an expert called by complaint counsel, having conducted the study with twenty subjects each in the Aspercreme and aspirin cells, a number well below the recommended sample size, the results were further broken down into subsets that are so small as to make comparisons among them meaningless (Roth, Tr. 1580–81, 1584–85). For example, Table III at CX 200D shows that for patients who were experiencing severe pain at the start of the study, 14% of the subjects in the aspirin pills/placebo cream group subsequently rated their pain relief as "poor," while the same percentage (14%) of the subjects in the TEA/S cream/placebo pills group self-rated their pain relief experience as "excellent." The number of subjects involved in the table is seven in all, five in the TEA/S group and two in the aspirin group (who were experiencing severe pain at the start of the study). Thus, the 14% figures in fact mean *one* subject who experienced

"excellent" pain relief and another subject who experienced "poor" pain relief. Use of percentages based on cells of one or three patients is a breach of the accepted way in which comparisons are made, distorts the degree of difference in the test and control subjects' responses to the test substances and may lead to misleading conclusions (Roth, Tr. 1574–77, 1583). Respondent's own expert, Dr. Ehrlich, conceded that because of the sample sizes, the results do not constitute scientific, statistical proof and are merely suggestive (Ehrlich, Tr. 4164–65).

262. Complaint counsel's experts also criticized the *composition* of the small sample—specifically, that there was an unacceptably wide array of conditions and diseases among the subjects (Adriani, Tr. 1188). The forty subjects were experiencing pain from one or more of the following diverse diseases or conditions: osteoarthritis, rheumatoid arthritis, bursitis, tendinitis, myositis, fibrositis, muscle spasms, myalgias, sprains and strains (CX 213F–Z–057). According to rheumatologist Dr. Roth, it is inappropriate to compare arthritis of the hip to a strain in a non-weightbearing area (Roth, Tr. 1579). If there were subpopulations of significant size in the Golden Study, comparisons could appropriately have been made about the effect of the different treatments on persons suffering the same or similar conditions. As it is, however, the study is "comparing apples, oranges, tomatoes and peanuts" (Roth, Tr. 1579). In order to show a product's efficacy for arthritic pain, the study must have an adequate number of patients of each type of arthritis as subjects in the study (Adriani, Tr. 1189; CX 269, p. 69,862). Because the Golden study did not have sufficient number of subjects in the treatment group and in the control group of each type of syndrome represented among them, the study does not provide a reasonable basis for making analgesic efficacy claims as to particular medical conditions (Adriani, Tr. 1198). [80]

263. There were other flaws in the methodology of the Golden study. One of the more important is the fact that the study did not screen out aspirin non-responders (Golden, Tr. 2805; Roth, Tr. 1581). For this reason alone, the FDA rejected the Golden study, indicating that the inadequate history of aspirin use among the test subjects, and the study's failure to screen out non-responders to aspirin, preclude acceptance of the treatment comparison because of the potential bias against aspirin in treatment responses and adverse reactions (Adriani, Tr. 1191; Roth, Tr. 1582; CX 443; *see* CX 342B).

264. Another significant problem with the Golden study concerns the data forms completed for each of the study subjects: the Background and Clinical Data form and the Patient Reporting Card form. These forms were defective in that, with respect to the substantial number of patients having multiple areas of pain, it was impossible

to determine from their forms where the patients had applied the cream and which area(s) of pain had been relieved (Golden, Tr. 2875-76; Marlin, Tr. 3378). Most of the Golden study subjects had at least two affected areas of pain (Golden, Tr. 2969; CX 213F-Z-057).

265. According to Dr. Marlin, the reason that patients were not asked to identify the specific site(s) of pain relief was that at the time the Golden Study protocol was designed, the focus of the study was on pain relief generally (Marlin, Tr. 3204). The implication of non-specificity in these forms, however, is that since the patient reporting forms used in the Golden study were similar to those subsequently employed in the Golden and Altschuler study (RX 50/CX 214), the inability to determine the *location* of pain relief from the forms detracts from the result claimed from the latter study that Aspercreme achieved statistically significant pain relief in non-weightbearing areas of the body.

266. A further problem that compounded the failure to pinpoint the location of pain relief on the Golden study patient forms is the fact that rheumatic disease, and particularly arthritis, is cyclical in nature. Thus, a study subject could come in with pain in the shoulder, but three days later could experience pain in the back or hip (Golden, Tr. 2880-81). The actual site of cream application thus could be different from the location of pain recorded on the diagnostic portion of the patient forms (*see, e.g.,* CX 213Z-030).

267. Also, as regards to completion of the patient forms, Dr. Golden acknowledged that due to the way the Clinical Data form and Patient Reporting form were designed, if a subject had six affected body areas of pain, the subject would record [81] "partial relief" rating regardless of whether he or she experienced pain relief in only one area or five. And there is no way on the face of the form that the person reviewing it could tell exactly in which affected area or areas the pain relief occurred (Golden, Tr. 2887).

268. Another problem with the Golden study is that several test subjects (seven in number, comprising 18% of the sample) were found to have taken one or more concurrent analgesic, antirheumatic, or mood-altering drugs (CX 45Z-022, Admission No. 4 (patients 1, 2, 6, 8, 10, 24, 31); CX 213S (patient 8)). The drugs included Tylenol, Medrol, Valium and Librium. Use of such concomitant medications is unacceptable in a non-crossover study and may have seriously affected the study results (Adriani, Tr. 1192; Roth, Tr. 1577). Moreover, since the subjects were not given a washout period from preexisting aspirin usage, it is unclear what was being measured as far as subjects in the aspirin/placebo cream group were concerned (Adriani, Tr. 1190-91). Thompson's expert, Dr. O'Brien, agreed that subjects using a significant amount of another analgesic or anti-inflammatory drug

should have been dropped from the data base (O'Brien, Tr. 3759–60). However, if you delete the data for these patients in order to eliminate the problem of concurrent medications, you further reduce the sample size of each subset, with the result that the value of the reported results is further diminished (Marlin, Tr. 3415–16).

269. The record also shows instances of significant protocol breach. For example, Dr. Golden included patients with articular (*i.e.*, joint) pain, patients who were outside the age parameters specified in the study protocol, and patients with mild to moderate pain as study subjects. These were not trivial deviations.

270. Departures from a study protocol should be minimized, and any major change or amendment to the protocol should be in writing. Dr. Golden did not make any written changes to the study protocol set forth at CX 213A–C (Golden, Tr. 2785). Although Dr. Golden testified that the protocol was subsequently amended orally, he was unable at his deposition to recall any amendments, either written or oral, to the study protocol indicated at CX 213A–C (CX 45Z–005 (Admission No. 257)). The claimed oral modification of the study protocol is also contrary to respondent's admission that Dr. Golden had "inadvertently" included patients with arthritic conditions as subjects in the CX 213 study (Golden, Tr. 2800; CX 45N (Admission No. 268)).

271. As regards the age range for subjects specified in the study protocol, Dr. Golden acknowledged that at least thirteen of the forty subjects (about 30%) were outside the age parameters specified (Golden, Tr. 2804). And despite the [82] protocol requirement that study subjects have moderate or severe pain, at least six of the forty subjects had only mild to moderate pain symptoms (Golden, Tr. 2831–32, 2834–35).

272. Another problem with the Golden study is the lack of consistency in Dr. Golden's "global evaluations" of his patient's condition following their participation in the study, which reflected his own subjective global opinion and was not based on any numerical scoring system (Golden, Tr. 2850, 2853, 2857–58). As a result, Dr. Golden was less than convincing in explaining some of his "global evaluations" at trial.

273. There are also some questions about the validity of the study's blinding process, based on comments by subjects about headache from the test agent's odor, and bitter taste (Roth, Tr. 1578–79). Finally, there are acknowledged errors in two tables and on three out of the six pages of textual material in the published report (Golden, Tr. 2923; Marlin, Tr. 3239–41, 3246; CX 200, Tables I and III, and pages B, C, and D). Dr. Marlin's explanation of the errors in the two tables was that they stemmed from the fact that data from different sources were

inappropriately combined and patient ratings of degree of pain were confused with the doctor's ratings (Marlin, Tr. 3243, 3246).

274. For all of the foregoing reasons, the Golden study (RX 48/CX 200) is not an adequate and well-controlled study, and its results cannot be relied on to demonstrate the efficacy of Aspercreme for pain and anti-inflammatory relief in this proceeding.

B. *The Golden And Altschuler Studies (RX 50/CX 214)*

275. In 1977, Dr. Steinberg asked Dr. Marlin to design and develop a second study for Aspercreme, a study that would compare Aspercreme to a placebo cream (Marlin, Tr. 3254). Dr. Marlin decided to use two doctors and two sites so that a large patient population could be tested. Dr. Stanley Altschuler, an internist, was chosen as the second investigator and Dr. Golden again served as the rheumatologist (Steinberg, Tr. 5157–58). Dr. Marlin again drafted the protocol and reviewed it with the two investigators. The patients were to be divided into two groups, one which would apply the placebo cream and one which would use Aspercreme (RX 50). Dr. Marlin periodically visited each of the two investigators to monitor the study and to ensure that the protocol was being followed by both investigators (Altschuler, Tr. 3010, 3065; Golden, Tr. 2710; Marlin, Tr. 3257, 3259–61). [83]

276. Drs. Golden and Altschuler each instructed their patients to apply as much of the topical medication to the affected area as was possible and to record the pain relief experienced over a four hour period—at the one-half hour, one hour, two hour, and four hour marks (Altschuler, Tr. 3015–16; Golden, Tr. 2719–21).

277. Prior to the commencement of the studies, it was decided that the protocol should be changed to raise the maximum age allowable in the patient population because Dr. Golden was having difficulty finding patients that fit within the original protocol. The exclusion of patients with rheumatoid arthritis or osteoarthritis was also modified to allow for the use of these patients provided they had non-articular features which could be treated by the cream (Altschuler, Tr. 3085–86; Golden, Tr. 2714–17). These changes in the written protocol are not serious since the purpose of the study was to test the pain relieving properties of the test drug on non-articular involvement (O'Brien, Tr. 3755).

278. Dr. Freudenthal followed the same basic procedures that she had utilized in the Golden study. She prepared the randomization and the code, packaged the medication in unmarked boxes, then opened the code and analyzed the data after the study was completed (Freudenthal, Tr. 4915–16).

279. The Golden and Altschuler studies was thus a double-blind study, using ninety-six patients at two different sites, which tested

Aspercreme against placebo cream for the relief of various types of musculoskeletal pain. The results of the studies, including Dr. Marlin's 1981 analysis (RX 368F–I), fail to show any statistically significant differences overall between Aspercreme and placebo for pain relief (F. 281, *infra.*). This study was rejected by the FDA in the Tentative Final Monograph on OTC Analgesic Products, dated February 8, 1983 (CX 443D). The reason given by the FDA was:

> . . . Of the six results reported, only one was statistically significant. Furthermore, the selective reporting of these six results renders this report uninformative, and no conclusion can be made concerning the effectiveness of trolamine salicylate [TEA/S].

280. According to Thompson's expert witnesses, the results of the study indicated a clear tendency toward greater pain relief with Aspercreme than with the placebo creme at the one-[84]half hour and one hour marks. Twelve patients using Aspercreme, as against ten using the placebo, experienced complete relief at the end of at least two of the four time periods. And 58% of the Aspercreme subjects, as against 30% of the placebo subjects, reported reiief for eight or more hours (Freudenthal, Tr. 4924–25; RX 82, 84). In patients who suffered from cervical (neck) pain, significantly more patients obtained relief with Aspercreme than with the placebo. This difference was statistically significant at the 95% confidence level (Freudenthal, Tr. 4925–26; Marlin, Tr. 3272; RX 82, 84). Groups of patients with pain in other areas were not large enough in size to compare, but analysis of the data in terms of weightbearing and non-weightbearing areas revealed that there is statistical significance for the superiority of Aspercreme at the one-half hour mark for non-weightbearing areas and joints, and in the cervical area, there is statistical superiority at one-half hour, one hour, and two hour marks (Freudenthal, Tr. 4925; Marlin, Tr. 3277).

281. The record shows that the overall results of the Golden and Altschuler studies fail to show any statistically significant differences between Aspercreme and placebo for pain relief (Adriani, Tr. 1195–96; Freudenthal, Tr. 4988; O'Brien, Tr. 3834; Roth, Tr. 1585; CX 45Z–021 (Admission No. 1); CX 214L). Three separate analyses of the data, including the initial analysis by Dr. Freudenthal (Freudenthal, Tr. 4988), and the subsequent reanalyses of the data first by Dr. Winick (Marlin, Tr. 3425–26) and later by Dr. Marlin (CX 45Z–021, (Admission No. 1); CX 214L), reached the same conclusion in this respect. Even using the Marlin analysis of 1981, it would be fair to say that none of the overall figures approached statistical significance at the 95% confidence level (Ehrlich, Tr. 4195; CX 214L). Rather, the likelihood that the differences measured were due to chance ranged from

slightly under 20% to over 90%, depending upon which time period is considered (*See* CX 214L).

282. Thompson relies heavily on the Marlin analysis, particularly on the subgroup involving non-weightbearing areas and joints, the only subgroup where statistically significant differences favoring Aspercreme could be shown on some of the time parameters (*See* Marlin, Tr. 3276, 3282; O'Brien, Tr. 3834). However, the Golden and Altschuler studies cannot fairly be interpreted as providing any reliable evidence of Aspercreme's superiority to placebo, even in non-weightbearing areas.

283. The original analysis of the Golden and Altschuler data by Dr. Freudenthal did not conclude that Aspercreme was superior to placebo in the non-weightbearing areas (Steinberg, Tr. 5246–47). In fact, placebo was equal or superior to [85] Aspercreme in three out of the five non-weightbearing areas that Dr. Freudenthal analyzed (*i.e.,* hands, shoulders, and arms) (*Id. See* RX 85J–L). Of the two areas where Aspercreme was superior to placebo (*i.e.,* cervical and back), only one (pain relief in the cervical area) was statistically significant. However, there were not enough subjects with cervical *arthritis* in the study for Dr. Freudenthal to reach a conclusion about statistical significance with respect to arthritis in the cervical area (Freudenthal, Tr. 4996). The fact that Dr. Freudenthal did not find that Aspercreme was superior to placebo in non-weightbearing areas is entitled to considerable weight. Not only was Dr. Freudenthal's the first and contemporaneous analysis, but also her analysis employing a nonparametric statistical test (Freudenthal, Tr. 4958–59) was of greater value than Dr. Marlin's later reanalysis employing a parametric test (O'Brien, Tr. 3838–39).

284. It is significant to note that the distinction between weightbearing and non-weightbearing joints and areas came not from the study protocol or Dr. Freudenthal's biostatistical report, but from a computer analysis done by Dr. Marlin in 1981, three years after the study was conducted (Marlin, Tr. 3423; Steinberg, Tr. 5245). Such *post hoc* analysis of clinical data calls into question the integrity of the result because of the potential bias present in any rearranging or manipulation of data (Roth, Tr. 1591–92).

285. The rating scale to be used in a study should be developed and set forth in the protocol before the study is begun so as to avoid data manipulation (Adriani, Tr. 1199–200; O'Brien, Tr. 3757, 3759; Roth, Tr. 1591–92). The record shows that the scaling system used in the Golden and Altschuler studies (RX 50/CX 214) was developed by Dr. Marlin long after he had broken the code, learned what the raw data showed, and read Dr. Freudenthal's original biostatistical report (Marlin, Tr. 3423, 3427–28). This is an improper procedure and ren-

ders the results questionable (Adriani, Tr. 1199–200; Roth, Tr. 1591–92). Dr. Marlin acknowledged that the results of the Golden and Altschuler study can be significantly affected by the type of scaling system used (Marlin, Tr. 3429). The record demonstrates that Dr. Marlin's scaling system have affected the analysis in favor of Aspercreme (*See* CPF 354).

286. Another problem with the Marlin analysis of non-weightbearing joints and areas is the nature of the underlying data. The patient report forms used in both the Golden and the Golden and Altschuler studies did not require the patients to distinguish between weightbearing and non-weightbearing parts of the body in recording pain relief (Marlin, Tr. 3365). Moreover, for patients having two or more areas of pain, it was impossible in the years following the study to determine from the patients' [86] forms exactly the area(s) of the body patients applied the cream to and the areas of the body the pain relief ratings came from (Altschuler, Tr. 3062, 3065, 3066–69; Golden, Tr. 2954–56; Marlin, Tr. 3378). There were also many instances where the data summary sheets (CX 366Z–114–19) and the entries in individual patient forms were not in agreement (*See* Marlin, Tr. 3375–91).

287. It is well-recognized that if a body of data is divided into a large number of small cells, some statistically significant differences will eventually appear among some of them (*See* Marlin, Tr. 3433–34, 3475; O'Brien, Tr. 3841–42; Roth, Tr. 1587; (CX 417 received at 3847, 3848–49; CX 435F–G received at 3853, 3856)). This is called random statistical significance (Marlin, Tr. 3475; Roth, Tr. 1587–88). In the Marlin analysis, the summary table shows no statistically significant differences in the total sample (Roth, Tr. 1586; *See* CX 214L). The fact that after the data is divided into a large number of subsets, a few differences in the non-weightbearing areas can be shown to favor Aspercreme at statistically significant levels is consistent with the concept of random statistical significance (Roth, Tr. 1586–88).

288. Apart from the major problems related to data analysis and interpretation discussed hereinabove, the Golden and Altschuler studies suffer from several significant flaws in its design and execution. As with the earlier Golden study, the patient population included an unacceptably wide array of conditions and diseases (Roth, Tr. 1589–90).

289. There is also some question regarding the propriety of pooling the Golden and Altschuler study data in this case.

290. In the Golden and Altschuler study, the decision to involve a second investigator occurred after Dr. Golden's portion of the test had begun (CX 45Z–003 (Admission No. 213)). The study protocol did not provide for a multi-site clinical trial (CX 214Z–022–024). The study was to consist of 100 subjects to be studied by Dr. Golden. Only when

Dr. Golden expressed his doubts about finding the requisite number of subjects after his study got under way, the study was changed to a multi-site study (Marlin, Tr. 3255–57).

291. It is a requirement of a multi-site study that not only the same protocol be adhered to by all investigators, but also the patient groups be homogeneous in order that the data obtained from the different groups may be combined (Marlin, Tr. 3259–60; O'Brien, Tr. 3831). If the patients in the different groups are dissimilar or if they are being treated for different conditions, pooling the data is inappropriate (O'Brien, Tr. 3831). In the Golden and Altschuler study, [87] Dr.Golden, a rheumatologist, provided mostly rheumatology patients while Dr. Altschuler, an internist, provided general medical patients (CX 45N (Admission No. 253)). There were other significant differences between the patients in the two groups to render pooling of the data questionable (Roth, Tr. 1592–93). For example, in Dr. Altschuler's group, thirty-two of the fifty patients (or 64%) self-rated their baseline pain as severe while only four of Dr. Golden's forty-five patients (or 11%) did so (Altschuler, Tr. 3086–87). Dr. Altschuler attributed this difference to the differences in the underlying conditions of the two patient groups rather than to the differences in their pain perception (Altschuler, Tr. 3087–90).

292. It is also important to determine that the results obtained by the investigators are similar before pooling the data in a multi-site study (O'Brien, Tr. 3815). Thus, the criticism of the FDA's Bureau of Drug directed to the Golden and Altschuler Study and its underlying data submitted by Thompson, included a comment that the study reported the diagnosis and location of the pain on one table for both groups and the statistical analyses treated all ninety-six patients without distinguishing investigators (CX 342B).

293. It is also important in a multi-site study that the different investigators adhere to the same protocol (O'Brien, Tr. 3815). In the Golden and Altschuler study, however, both investigators stated that they knew of no checks to insure that the two physicians conducted the test in the same manner (CX 45I (Admission No. 140); CX 45N (Admission No. 256)). Thus, there is no assurance that the two physicians applied the same criteria in gathering the clinical data and background information on the patients, or that they identified the primary diagnosis or the primary site in the same manner (*Id.*). Thompson has admitted that Drs. Golden and Altschuler never discussed any aspect of the test with each other (CX 45N (Admission No. 255)). As of the time of Dr. Golden's deposition in this case (December 7, 1981), the two physicians had never even spoken to one another (CX 45M (Admission No. 241)). In fact, Dr. Altschuler testified that during his conduct of the study, he was unaware that another investigator

was conducting a trial with a protocol that was identical to his (Altschuler, Tr. 3059).

294. Another problem with the Golden and Altschuler study is the fact that nine subjects (or about 10% of the total sample) at the time of their participation were using anti-inflammatory or mood-altering drugs which may have distorted the study results (Adriani, Tr. 1198; Roth, Tr. 1588–89; CX 45Z–016–17 (Admission No. 5) (patients, 101, 105, 109, 130, 131, 132, 135, 139, 140)). The drugs included tranquilizers such as Valium and Librium, and anti-inflammatory drugs such as [88] Prednisone and Motrin. In view of the fact that the study was not a crossover study, the use of such concomitant medications should have been discontinued (Adriani, Tr. 1198; Roth, Tr. 1588–89).

295. Although the protocol of the Golden and Altschuler studies prohibits concomitant use of "other analgesic medication" during the four-hour test period, neither of the two physicians was instructed about medication usage in the period *prior* to the four-hour test period, nor was either instructed as to specific types of non-analgesic medications which could affect study results if used during the test period (Marlin, Tr. 3396–98). Dr. Altschuler admitted that he did not question study participants after the test about any concomitant pain medications that they might have used either before or during the four-hour test period and that some subjects, especially those who applied the test cream after a lapse of time following their initial visit with him, could have taken analgesic medication *prior to* commencing the four-hour study period (Altschuler, Tr. 3082–83). Such analgesic medication by subjects, Dr. Altschuler agreed, would not have violated his instructions yet could have affected the test results reported by the patient during the four-hour test period. Thus, because of the lack of a washout period for analgesic medications prior to the subjects' participation, and because a number of study subjects took concurrent anti-inflammatory or mood-altering drugs which could have affected study results, concomitant medication usage is a significant problem in the Golden and Altschuler study.

296. In addition, there were several patients in Dr. Altschuler's Aspercreme group who are known to have breached the protocol by applying the cream two times rather than once (patients 11, 30, 32, and 52 (CX 214Z–079, Z–096, Z–098, Z–112)), all of whom recorded that they had experienced pain relief (CX 366Z–114–19). This raises a question of potential bias in favor of the Aspercreme group.

297. Dr. Golden testified at trial that the written protocol, requiring exclusion of patients with diagnosed rheumatoid arthritis or osteoarthritis as well as patients older than fifty-five years, was subsequently modified orally to allow inclusion of arthritis with *non-articular* pain and persons of older age (Golden, Tr. 2714–17). This testimony is

contrary to his deposition testimony where he had recalled no written or oral amendments to the protocol (Golden, Tr. 2937). In any event, the patient's forms for some twenty-five subjects indicated *arthritic pain* and some others only name the affected area or areas of the body. With respect to those subjects, it is not possible to determine from their patient forms whether the pain was of non-articular nature and whether their inclusion [89] was proper under the orally-amended protocol (CX 214Z–060, Z–070–72, Z–077, Z–078, Z–081–82, Z–084–92, Z–094–95, Z–097–98, Z–100, Z–102, Z–104, Z–106, Z–108–11, Z–113–16, Z–118–119).

298. For all of the foregoing reasons, the Golden and Altschuler study (RX 50/CX 214) is not an adequate and well-controlled trial and does not constitute a reasonable basis for Aspercreme efficacy claims. This determination is in accord with that of the FDA Final Tentative Monograph for OTC Analgesic Products, published on February 8, 1983 (CX 443D).

C. *The French Studies*

299. The French studies relied on by Thompson as substantiation for Aspercreme efficacy claims include the two clinical studies conducted in France for the L'Oreal Corporation by Dr. Alain Patel (RX 34/CX 209) and Dr. Pierre Andre Chappelle (RX 35/CX 208), respectively, and a follow-up study conducted by Dr. Patel (RX 36/CX 120), all during the period 1976 and 1977. A June 4, 1981 statement authored by Dr. Patel (RX 37/CX 253) and a July 6, 1981 letter of Dr. Patel to Dr. Steinberg of Thompson (RX 38/CX 266) also pertain to the Patel studies (RXs 34, 36). Thompson acquired RXs 34 and 35 in early 1977 (Steinberg, Tr. 3139–40) and RXs 36–38 in the summer of 1981. Thompson's Aspercreme advertisement began on a nationwide basis in 1977. These French studies were conducted to meet the French regulatory requirements by government designated investigators. For our purposes, they were uncontrolled and do not permit a proper assessment of their results. *See* the FDA Tentative Final Monograph on OTC External Analgesic Products, dated February 8, 1983 (CX 443D). In any event, they fall far short of adequate and well-controlled clinical trials and cannot be relied on as providing a reasonable basis for making any efficacy claim for Aspercreme.

300. At the time when Thompson purchased the product from the Sperti Drug Company, Inc. in 1976, two studies on the efficacy of Aspercreme were in progress in France. These studies were conducted for the L'Oreal Company ("L'Oreal") which sought to obtain a license to sell Aspercreme in France. Under the French regulatory scheme, a drug must undergo toxicology studies and clinical trials designed to show its safety and efficacy (Patel, Tr. 1817–18, 1825). The clinical

trials must be conducted by two French physicians whose names appear on the French Ministry of Health list of clinicians approved for such trials (Patel, Tr. 1818, 1826–27). The two studies for L'Oreal were conducted by French physicians, Drs. Alain Patel and Pierre Andre Chappelle. However, L'Oreal subsequently decided [90] that because of a change in the French Social Security regulations it would not be profitable to market the product in France (Patel, Tr. 1920). Thompson received the results of these studies in the early part of 1977 (Steinberg, Tr. 5137–40).

301. The patient population for these two studies was drawn from the Rehabilitation Center of the hospital in Deauville, France and the Raymond Poincare Hospital in Paris, France. Dr. Chappelle, head of the Rehabilitation Center and a well-known expert in the rehabilitation of rheumatoid and traumatic injuries, supervised the study at the Deauville site. Dr. Patel supervised the Raymond Poincare site. The patients who participated in the study were suffering from pain and swelling either as a result of a rheumatologic disease or a traumatic injury. All of the patients at Dr. Chappelle's site were hospital inpatients, all of those at Dr. Patel's site were out-patients (Patel, Tr. 1868–71, 1875). According to Dr. Patel, in initial meetings with representatives from L'Oreal, Drs. Patel and Chappelle decided that they would observe the effects of the drug over a two-week period and would confine the study to pain caused by trauma and pain in and around the joints. It was decided that fifty patients would be evaluated, twenty-five from Dr. Patel's hospital and twenty-five from Dr. Chappelle's Rehabilitation Center. Drs. Chappelle and Patel worked closely together and conferred on the instructions to be given to the patients and the reporting form which would be used to record the results. According to Dr. Patel, the test was structured in a standard fashion that had been used many times before to test anti-inflammatory and analgesic preparations (Patel, Tr. 1872–76). Also, patients were told to apply the cream to the painful area twice a day, or three times a day if needed. The patients were seen by the doctors three times during the course of the study—at the beginning, after one week, and after two weeks. The total patient population numbered fifty-two (Dr. Patel included two additional subjects), a number considered adequate for drug studies in France (Patel, Tr. 1875–76, 1881–82, 1976).

302. Reports from clinical examinations were compiled on relief of pain, swelling, inflammation, and on improvement in ease of movement (RXs 34, 35). Results of the study were recorded on the patient's medical record and data collection forms. According to Dr. Patel, neither the doctors nor the patients knew the contents of the unmarked tubes of test drug received from the sponsor and sealed en-

velopes contained the identity of the contents of each bottle. According to Dr. Patel, this is standard practice for drug testing in France (Patel, Tr. 1876–77, 1879, 1881, 1962, 1996). Dr. Patel also testified that, in forming their conclusions, the physicians also consulted the medical charts they maintained for each patient as well as the clinical data reported on the data [91] collection forms. When the study was completed, they studied the charts and the clinical case forms before writing their recommendations to the Ministry of Health (Patel, Tr. 1962, 1996).

303. Nineteen of the twenty-seven patients at Dr. Patel's site were reported to have shown "good results," and all but one of the twenty-three patients at Dr. Chappelle's site were reported to have "noticed a very clear improvement" (RXs 34A, 35D). According to the investigators, these findings indicate that test medication was very effective in relieving muscle aches, pain from tendonitis, and pain from inflammatory disease. No results were observed where the patient was suffering from serious arthritis affecting large, weightbearing joints (Patel, Tr. 1906–07, 1918–19, 1931; Steinberg, Tr. 5142; RXs 34, 35).

304. Dr. Patel testified that in February or March of 1977, he conducted an informal follow-up study of Aspercreme in order to satisfy himself that the product did work as well as his earlier findings indicated. This time he knew that the cream he was administering was Aspercreme, and he used the product on approximately forty patients and kept records on twenty-five. Dr. Patel testified that the second study results confirmed the findings of the first. Dr. Patel concluded that Aspercreme is effective in providing relief of pain and swelling and in improving facility of movement in cases where there is rheumatic involvement around the joint. He also concluded that Aspercreme is effective in cases that have rheumatic participation inside the joint, that is, in the synovial fluid. Furthermore, patients with arthritis of the small, non-weightbearing joints get good relief of pain when using Aspercreme (Patel, Tr. 1920–25, 1931–32). Dr. Patel testified that he was so impressed with Aspercreme that he has used it since for his hands and has continued to recommend it to patients who are able to purchase Aspercreme in this country (Patel, Tr. 2042, 2045).

305. However, the record shows clearly that neither of Dr. Patel's studies (RXs 34, 36) constitutes a well-controlled, double-blind clinical study. Dr. Patel's studies consist mainly of clinical observations expressing a global evaluation of the product (Roth, Tr. 1604–05). There was no written protocol for either RX 34 or RX 36 (Patel, Tr. 1980), no scoring or scaling system for pain relief, no record of the subjective pain responses obtained from the patients (Patel, Tr. 1983–84), and no

information on concomitant medications (Roth, Tr. 1604–05; Adriani, Tr. 1214). Both investigations also involved self-limiting conditions that were not taken into account in the studies' design (*Id.*). The studies are notable in their lack of adequate data entry and analysis customarily found in [92] other reports of clinical trials. Finally, the Patel studies are seriously flawed by the absence of a placebo or any other control and the unblinded conditions under which his observations were made (CX 342C).

306. The Chappelle study (RX 35/CX 208) shares all the flaws discussed hereinabove with respect to the Patel studies (*See* Adriani, Tr. 1215).

D. *The Batterman And Sanders Myoflex Study (CX 254)*

307. Thompson also relies on a Myoflex study conducted by Drs. Batterman and Sanders (CX 254/CX 344Z–148–56).

308. This was a double-blinded, placeblo-controlled, multi-center study to which Dr. Batterman contributed twenty-eight patients and Dr. Sanders thirty-five. The study employed a cross-over design and compared the efficacy of Myoflex cream (a 10% topically-applied TEA/S ointment like Aspercreme) with that of placebo cream in patients with arthritic involvement of the hands. The nature of a cross-over design is that each subject in the study uses the test and control agents sequentially, and the subject as well as the investigator are blinded (Roth, Tr. 1534).

309. The Batterman and Sanders study employed a total of six measures, or three measures for each of the two groups. There were two objective measures (hand grip strength and finger joint circumference) as well as one subjective measure (global improvement) for each of the two groups. The results showed no difference in patient response between Myoflex and placebo cream in five out of the six measurements taken between the two groups. Neither investigator found any difference between TEA/S and placebo cream in terms of either of the two objective measures of improvement. Also, Dr. Sanders found no difference between TEA/S and placebo in terms of patients' subjective impressions of improvement. But Dr. Batterman reported a significant difference between TEA/S and placebo in terms of patients' subjective impression.

310. For several reasons, the Batterman and Sanders study cannot be regarded as adequate support for Aspercreme efficacy claims. First, as was emphasized in the FDA's Tentative Final Monograph on OTC External Analgesic Products, on five out of the six parameters used to measure drug efficacy, TEA/S was no more effective than placebo (CXs 343B, 443D). In light of these results, the FDA concluded that the study does not indicate any clear superiority of TEA/S over

placebo (CX 443D). Secondly, in [93] terms of the subjective impressions of improvement reported by subjects in Batterman's group, the report lacks any information as to what subjective measure(s) of improvement was employed (Adriani, Tr. 1201–03; Roth, Tr. 1595–96). It may have measured the patient's impression of reduced pain or improved function, and the improvement may or may not have been clinically significant (Adriani, Tr. 1202–03; Roth, Tr. 1594). Without knowing what questions the patients were asked by the doctors, the "subjective improvement" parameter is too vague to be relied on (Roth, Tr. 1597). For this reason, the FDA External Analgesic Panel considered the Batterman and Sanders study to be not adequate and well-controlled. It felt that the report relied heavily on the subjective improvement reported by the Batterman subjects but did not indicate what the subjective improvement consisted of (Adriani, Tr. 1459).

311. There are other important information gaps in the Myoflex study. It lacks information on concomitant medication usage by the subjects, on the frequency and duration of applications, on the type of blinding techniques used, and on how study dropouts were treated (Adriani, Tr. 1204; Roth, Tr. 1598). The inclusion of ten subjects listed as being in a "quiescent phase" also means that those patients had no active disease (Roth, Tr. 1596).

312. In view of the foregoing omissions and problems, the Batterman and Sanders study is not an adequate and well-controlled clinical trial. In any event, this study was not seen by Thompson before it began Aspercreme advertisements, for Thompson acquired it sometime between 1979 and 1981 (Admissions, CX 45D, P).

E. *The Bioavailability Studies*

313. A drug is said to be "bioavailable" when it has been absorbed into the body and is present in the blood, urine, or other body tissue or fluid. A drug is said to be "bioactive" when it also shows a significant therapeutic effect in the human body. For example, if a person with a bacterial infection takes an antibiotic that is generally recognized as being effective, but the strain of bacteria causing the infection is resistant to that antibiotic, the antibiotic will in fact get into the person's system and thus be "bioavailable," but not "bioactive" in that its presence in the body will not show a therapeutic effect (Adriani, Tr. 1178–79).

314. According to the FDA, demonstrating that a drug is bioavailable and demonstrating its efficacy are not the same thing: [94]

> It is not . . . the intent of a bioavailability study to demonstrate effectiveness. The purpose of a bioavailability study is to determine the rate and extent of absorption. If a drug product is not bioavailable, it cannot be regarded as effective. However, a

> determination that a drug product is bioavailable is not in itself a determination of effectiveness. The requirement of evidence of bioavailability is intended to supplement, no[t] replace, clinical evidence of effectiveness.

42 FR 1640 (1977).

The record in this proceeding also clearly shows that bioavailability studies are not a substitute for well-controlled clinical trials for the purpose of showing the effectiveness of a drug (Adriani, Tr. 1178; Ehrlich, Tr. 4087; O'Brien, Tr. 3964–66; Rabinowitz, Tr. 3519; Roth, Tr. 1566).

315. As part of its reasonable basis materials, Thompson heavily relies on a radioisotope experiment on dogs and humans conducted by Dr. Joseph L. Rabinowitz and others (RX 70/CX 374). The canine portion of the study involved ten dogs, five of which were given oral aspirin tagged with radioactive carbon-14 and five which were given radioactive TEA/S topically applied at the knee. The human portion involved six subjects who were first given radioactive aspirin orally, and two to six weeks later were given radioactive TEA/S topically applied at the knee. In each case, tissue and fluid samples were analyzed for radioactive material at specific intervals after the drug had been administered. The presence of radioactive materials in tissue samples will show drug penetration of skin and absorption into subcutaneous tissues. However, only clinical studies can demonstrate analgesic efficacy (O'Brien, Tr. 3868–69; Roth, Tr. 1601, 1728). Dr. Rabinowitz agrees that there is nothing in his study to show that TEA/S is an effective analgesic agent (Rabinowitz, Tr. 3518; *accord* Roth, Tr. 1599; Adriani, Tr. 1206–08).

316. In 1978, Thompson issued a grant to the University of Pennsylvania for a study that Dr. Joseph Rabinowitz wanted to conduct. From time to time after the study was underway, Dr. Steinberg of Thompson received from Dr. Rabinowitz preliminary written reports relative to the amount of salicylate available in tissues after the application of TEA/S as compared to the ingestion of aspirin. There were no real differences between the results reported in each of the preliminary reports [95] (Steinberg, Tr. 5163–66). Prior to the initiation of the study , three scientific committees at the Veterans Hospital reviewed and approved the proposed investigation. Approval by the committees required a finding by them that the study had scientific merit (Rabinowitz, Tr. 3499). Dr. Rabinowitz maintained full independence in conducting the study. The other participants in the study were physicians of the University of Pennsylvania specializing in arthritis and rheumatology, who had no contact whatever with Thompson (Rabinowitz, Tr. 3495–97).

317. The Rabinowitz study involved "tagging" the TEA/S molecule

with a radioactive isotope. The TEA/S was made radioactive at the New England Nuclear Company by using radioactive carbon dioxide (CO_2) and bubbling it with phenol to yield radioactive salicylic acid. The radioactive salicylic acid was then added to TEA to yield radioactive TEA/S (Rabinowitz, Tr. 3500–01, 3521). The salicylate molecule in the TEA/S compound was tagged with radioactive Carbon 14 (^{14}C). According to Dr. Rabinowitz, it is certain that the salicylate molecule retained the radioactive tag (Rabinowitz, Tr. 3503). There is no difference other than the radioactive carbon between the radioactive TEA/S used in the study and commercially available TEA/S (Rabinowitz, Tr. 3503–04). This fact was proven by use of a nuclear magnetic resonance (Rabinowitz, Tr. 3504).

318. The first stage of the Rabinowitz study was a canine study conducted on beagles. Beagles are considered to be good models to test the absorption of salicylate (O'Brien, Tr. 3890; Rabinowitz, Tr. 3505–06; Silverman, Tr. 2209). The study was conducted by rubbing Aspercreme into the shaved right knee of the dog until all of it was absorbed. After one hour, the area was wiped off with alcohol. The animal was sacrificed and the knee was cut off and sections were taken from the skin. Each section was weighed carefully and the tissue was extracted. Each section was then treated with ether and sulfuric acid to extract the radioactive salicylate. The extract was chromatographed for further purification, and the amount of salicylate present was measured by assessing the amount of radioactivity with a radioactivity counter (Rabinowitz, Tr. 3505, 3507–09). The amount of radioactivity measured represented the amount of concentration of salicylate in the tissue (Rabinowitz, Tr. 3511–12).

319. The results of the canine portion of the study showed that the skin, the muscle, and the fascia absorbed significant quantities of salicylate in all five dogs in the group. The data also revealed that the salicylate level in the blood in the Aspercreme group was 10 to 100 times lower than that of the aspirin group. [96]

320. In the canine study conducted by Dr. Rabinowitz, the following salicylate levels were found in body tissues following oral and topical administration:

	Oral	Cream
Muscle	1.76	38.20
Fascia	1.04	16.40
Fat Pad	1.00	5.60
Tendon	.20	3.00
Cartilage	.43	1.62
Synovium	.62	.74

These data reveal that TEA/S topical application resulted in higher local salicylate concentrations than did ingestion of oral aspirin in dogs and indicate that topical TEA/S was primarily absorbed locally by direct penetration (Rabinowitz, Tr. 3513–14; RX 70C–D).

321. The second stage of the study studied human patients with rheumatoid arthritis. All patients met American Rheumatism Association's criteria for classical or definite rheumatoid arthritis. Dr. Ralph Shumacher, Professor of Medicine at the University of Pennsylvania and a highly regarded rheumatologist, screened the patients for study eligibility. The same patients participated in both the oral aspirin and topical TEA/S parts of the study. Patients abstained from salicylates for six hours prior to each study period. Each patient first received orally 500 milligrams of ^{14}C aspirin. Two to six weeks later, ten gms. of the triethanolamine ^{14}C- salicylate cream was massaged into the skin over one knee. Blood and urine samples were obtained before the administration of either the oral or the topical medication and again at 60 to 120 minutes, at which time a synovial fluid aspiration was performed. The fluid samples were extracted, chromatographed, and measured for radioactivity (Rabinowitz, Tr. 3509–10; RX 70).

322. In the human study conducted by Dr. Rabinowitz, salicylate concentrations in the synovial fluid after the application of TEA/S were found to be approximmately 60% of the concentration found after the oral ingestion of aspirin. However, the concentration in the blood from orally ingested aspirin was four to eight times higher than that resulting from topical application of TEA/S. These data indicate that the TEA/S was absorbed by direct penetration into the joint through the skin since these levels were achieved despite low blood salicylate levels (RX 70). **[97]**

323. The Rabinowitz study shows that salicylate can be and is absorbed through the skin in measurable amounts and that the salicylate component of the TEA/S molecule is capable of penetrating through the skin, muscles, and tendons right down to the joint connecting the bones. Thus, Aspercreme can deliver salicylate to joints and tissues (Adriani, Tr. 1298; Ehrlich, Tr. 4030; O'Brien, Tr. 3675; Rabinowitz, Tr. 3513–14; Roth, Tr. 1728/7–12; Silverman, Tr. 2208; RX 70).

324. Dr. Howard Maibach, professor of dermatology at the University of California Medical School and a recognized expert in the field of percutaneous absorption of drugs, observed that while topical drug absorption was generally believed to be dependent upon being transported through the blood or the general circulatory system (the "microcapillary network") (RX 289), recent studies by Dr. Maibach, Dr. Jean Paul Marty, and others have demonstrated that a drug may be capable of penetrating into the body without being carried by the

blood (RXs 1000–05). These studies also show that subcutaneous drug levels can be achieved following the penetration of a topically applied drug into the layers of the body (RXs 289B–C, 1020). In Dr. Maibach's opinion, topically applied TEA/S is one of those drugs which diffuses into muscles and tissues beneath the skin (RX 289D). Dr. Maibach's paper, accepted for publication in the *Journal of Pharmaceutical Sciences*, reviewed some of the scientific literature in the area of subcutaneous delivery of chemical substances, including the Rabinowitz study (RX 70), the early St. Thomas Institute study (RX 45), and the Golden study (RX 49) and concluded:

> Better (or at least equivalent) therapy is possible, therefore, without systematic distribution of the drug, *i.e.*, significant blood levels, and possible side-effects (RX 102M).

325. Dr. Rabinowitz' bioavailability study is interesting in that it shows that topically applied TEA/S may be capable of delivering salicylate to subcutaneous body tissues by directly penetrating the skin and thus offer an alternative method of administering salicylate for relief of pain. What is needed to verify this potential, however, is an acceptable demonstration of TEA/S' bioactivity.

326. The record also shows some ambiguity as to precisely what chemical was carbon-14 tagged in the experiment itself. TEA/S was obtained by adding radioactive salicylate acid to TEA. Although Dr. Rabinowitz testified that there was no [98] difference between the radioactive TEA/S he used and the commercially available TEA/S and that the TEA molecule in the radioactive TEA/S could not have been tagged in the process, the question as to which of the four different chemical entities (the salicylate ion, salicylic acid, TEA/S or TEA) was measured in the radioisotope experiment remains in the record (Adriani, Tr. 1211 (salicylate ion, salicylic acid, or TEA/S); O'Brien, Tr. 3873 (salicylate ion); Rabinowitz, Tr. 3500–01 (salicylic acid); Roth, Tr. 1599–600 (TEA or salicylate)). There also is some evidence indicating that the sulfuric acid used to extract the tagged material from the samples could have caused the TEA/S to disassociate into TEA and a salicylate moiety (Adriani, Tr. 1209; Rabinowitz, Tr. 3536).

327. Thompson has also admitted that the human portion of the Rabinowitz experiment did not study whether TEA/S broke down into a salicylate ion in the body and that the canine portion did not study whether TEA/S broke down into salicylate in the body (CX 45Q (Admissions Nos. 354–55)).

328. The Rabinowitz data do not show that topically applied TEA/S in the experiment penetrated below the skin in therapeutically significant quantities (Adriani, Tr. 1263; Roth, Tr. 1599–600, 1724). Rather the study shows that most of the tagged material stayed on the skin

(Adriani, Tr. 1263; RX 70C (Table I)) and that the base was actually better absorbed than the tagged material (Rabinowitz, Tr. 3611-12; RX 70C). Dr. Roth, complaint counsel's expert witness, testified that the clinical relevance of the presence of the tagged material in any of the tissue or fluid samples is dubious (Roth, Tr. 1728). Furthermore, the record fails to answer many important questions that would have to be addressed. The Rabinowitz study does not show the rate at which the tagged material penetrated. It has been demonstrated, however, that if an analgesic is slowly absorbed, the minimum effective concentration of the drug at the site of action may never be reached (O'Brien, Tr. 3879-83).

329. Furthermore, there are some significant problems in the experiment's design. The dosage of radioactive aspirin used in the experiment (500 milligrams) is lower than the recommended single dose of aspirin for analgesia (650 milligrams) and is far lower than the recommended dose of aspirin for inflammation (4200 milligrams a day) (O'Brien, Tr. 3868; Rabinowitz, Tr. 3534; Roth, Tr. 1602). In contrast, Dr. Rabinowitz added 20% more radioactive molecules to the TEA/S in order to compensate for the TEA/S that would remain on the glove of the physicians who applied the cream (Rabinowitz, Tr. 3502). Also, although all six human subjects had been on a stable dose of oral aspirin for six months or more, they were instructed not to take aspirin only for six hours before each test period **[99]** (RX 70D). More than six hours, however, would be necessary for the nonradioactive aspirin to be totally cleared from the subjects' systems (Adriani, Tr. 1395; O'Brien, Tr. 3765-67; Roth, Tr. 1600). To the extent the nonradioactive aspirin remained in the body, it may have influenced the test results by diminishing the radioactive aspirin that could have been absorbed.

330. As part of its reasonable basis, Thompson relies on submitted documents (RX 42/CX 202; RX 62/CX 216) pertaining to blood and urine level tests on human volunteers. In both studies, topical TEA/S was applied and blood and urine samples were measured for salicylate at fixed intervals. The only scientific value of these studies is to demonstrate that topically applied TEA/S is absorbed into the blood and excreted in the urine (Adriani, Tr. 1178). Almost any drug applied to the skin will show up in minute traces in the blood. But, the serum levels of salicylate achieved did not reach the minimum levels associated with analgesia (Adriani, Tr. 1390; Roth, Tr. 1760-61). Moreover, in one test (RX 62), the site where the drug was applied was covered with saran wrap overnight. Covering the site of a topical application increases the rate of absorption. Thus, the resulting blood and urine levels of salicylate were substantially higher than they

would have been after normal consumer use (Adriani, Tr. 1229; Silverman, Tr. 2428–29).

331. In addition, Thompson has submitted two rabbit studies (RX 43/CX 215; RX 44/CX 204) measuring salicylate levels in rabbits after application of topical TEA/S. The scientific value of these tests, which involved a total of five rabbits, is questionable. In any event, for the reasons set forth hereinabove, these so-called penetration studies do not provide substantiation for the efficacy of topical TEA/S in humans for relief of musculoskeletal pain.

332. The Myoflex bioavailability studies Thompson refers to (CX 344G; Z–048–49; Z–063–65) simply show that salicylate was present in the blood following a topical application of Myoflex, a topical rub containing 10% TEA/S. The egg membrane experiment (RPF 202) and beef muscule experiment (RPF 203) referred to by Thompson are trivial and of little value to this proceeding.

333. Dr. Steinberg, Thompson's vice president who is responsible for substantiation of advertising claims, testified that Thompson relied on a 1955 article by Howell (Steinberg, Tr. 5175–76; RX 366/CX 366, pp. Z–222–23). Since Thompson acquired the Howell article toward the end of 1981, Thompson could not have relied on it for substantiation of any claims for Aspercreme made before that time. In any event, the Howell [100] article, which reports the results of a single-blind English study on diethylamine, cannot be used to substantiate claims for TEA/S, which is an entirely different drug that may not penetrate the skin in the same way.

F. *The Gaudin Patent*

334. Thompson also relies on certain patents as evidence of drug efficacy. A United States patent was issued in 1952 to Dr. Olivier Gaudin for his discovery (No. 2,596,674) of topical absorption of amine salicylates (RX 450/CX 212). It does not refer to TEA/S but to an entirely different compound, diethylamine salicylate (Adriani, Tr. 1288, 1243–44). Other than the patent holder's assertion that dissociation of diethylamine salicylate occurs, there is no other evidence of dissociation in the patent report (CX 212C). In addition, other patents have been issued by the United States Patent Office for different topical salicylate salts (Silverman, Tr. 2227–28; RX 451). These patents reflect a determination that some salicylate salts as described were patentable within the meaning of the patent laws, and the medical scientific community does not use or accept patents as a source of information on drug efficacy (Adriani, Tr. 1227). Patents are merely descriptive claims for compounds, and have no scientific significance for determining drug efficacy for any disease condition (Roth, Tr. 1609).

G. *Clinical Observations And Opinions Of Physicians*

335. It is natural that in the practice of medicine, the determination of what drug is most appropriate for an individual patient rests with the physician's professional judgment based on the patient's history and disease state and the physician's knowledge of and experience with drugs. However, the practice of medicine is not an exact science but an art and a physician's choice of a drug for a particular patient essentially reflects a process of trial and error based on long experience, insight and wisdom. However, it is something else to argue that clinicians' experience with patients with a particular drug should be accepted as scientific proof of efficacy. It is generally recognized by the medical scientific community that physicians' observations and opinions may suggest or lead to controlled clinical trials or be used to augment such trials, but they are not substitutes for well-controlled clinical trials for the purpose of showing drug efficacy (Adriani, Tr. 1436, 1460–61; **[101]** Roth, Tr. 1570). The contrary view expressed by respondent's experts, to the effect that the requirement for well-controlled clinical trials should be substantially relaxed or dispensed with in the case of OTC topical analgesic drugs, such as Aspercreme, do not reflect the prevailing view of the medical scientific community including the FDA. *See* 21 C.F.R. 330.10(a)(4)(ii); FDA OTC Drug Review Policy Statement, 46 FR 47,729, 47,731 (1979).

336. A physician's observation of his patient's response to an analgesic may be affected by bias (Adriani, Tr. 1181), or may be incorrect due to a variety of other factors, such as placebo effect (Ehrlich, Tr. 4155–56). For example, the enthusiasm the physician may consciously or unconsciously communicate to the patient may contribute to a high placebo response rate (Ehrlich, Tr. 4133–36). Moreover, there have been numerous instances where drugs used over a period of years with positive consumer response and physicians' observations were later subjected to clinical tests and found to be ineffective (Adriani, Tr. 1180–83; Ehrlich, Tr. 4117–18; O'Brien, Tr. 3775–76; Roth, Tr. 1571).

337. Physicians' observations and opinions based upon case reports, random experiences, and other reports lacking details necessary for scientific evaluation do not constitute adequate substantiation for Aspercreme's efficacy claims (F. 335–36, *supra*). 21 C.F.R. 330.10(a)(4)(ii). Thus, for example, letters such as RX 47/CX 260 which represent isolated, uncontrolled, and undocumented observations of physicians do not constitute scientific evidence (*Id. See* Adriani, Tr. 1230–32; Golden, Tr. 2763–65, 2767; Roth, Tr. 1609–12). On the other hand, where appropriately documented and systematic, physicians' observations and opinions may constitute reports of significant

human experience during marketing and may thus be viewed as evidence capable of corroborating, but not supplanting, clinical studies (F. 218, *supra*). 21 C.F.R. 330.10(a)(4)ii).

338. In 1982, B.F. Ascher & Co., Inc. ("Ascher"), the marketer of Mobisyl, another 10% TEA/S product, conducted a survey of certain physicians and health practitioners in an effort to determine their opinions of Mobisyl (Borchers, Tr. 5045–56; RX 346A–C). The study was submitted to the FDA in an effort to corroborate the results of clinical tests undertaken by Thompson Medical (Borchers, Tr. 5057–58; RX 346A). The submission to the FDA was made pursuant to 21 C.F.R. 330.10(a)(4)(ii), which provides that proof of effectiveness shall consist of controlled clinical investigations, which may be corroborated, *inter alia,* by reports of significant human experience during marketing (Borchers, Tr. 5058; RX 346A–B). [102]

339. Because the Ascher survey was neither possessed nor relied upon by Thompson prior to its dissemination of any of the challenged advertising, it does not aid Thompson in this proceeding (*See* CX 25). In any event, by virtue of the manner in which this survey was conceived and conducted, it is of little value in this proceeding even as corroborative evidence of TEA/S' efficacy (*See* CPF 395–99).

H. *Testimonial Evidence of Users*

340. A significant portion of Thompson's substantiation materials is devoted to testimonial evidence, both by consumers and by persons in health-related occupations. It is well-recognized that such testimonial evidence has no value in determining the issue of drug efficacy (Adriani, Tr. 1180; Roth, Tr. 1567). In FDA regulations and the OTC panel evaluations of analgesic drug efficacy, patient testimonials were not worthy of consideration (Adriani, Tr. 1239; CX 391F, 395B). 21 C.F.R. 330.10(a)(4)(ii). Since consumers are not incapable of evaluating drug efficacy, testimonial evidence is not a reliable source of evidence of drug efficacy (Adriani, Tr. 1239; Roth, Tr. 1617).

341. Thompson's own witnesses acknowledged the inadequacies of testimonial evidence as a basis for demonstrating drug efficacy. For example, Dr. O'Brien admitted that he had criticized pharmaceutical companies for their reliance on testimonials as evidence that Indomethacin (a prescription anti-inflammatory drug) is effective (O'Brien, Tr. 3786). He had also criticized the companies for their reliance on consumers' reports as to the type of pain relief they got from the drug (O'Brien, Tr. 3786–87). Dr. Ehrlich indicated that in dealing with consumers' reports, there is no way to eliminate the possibility that they were due to the placebo effect (Ehrlich, Tr. 4155–56). Consumer letters to companies also suffer from selectivity in that a company only hears from those who want to be heard (*Id.*). Thus, for example,

a nurse, who had returned a consumer response card favorable to Aspercreme and subsequently testified at trial, acknowledged that she probably would not have written a negative letter to a company even if she were "downright disappointed" in a product (Walsh, Tr. 4362).

342. The Arthritis Foundation has devoted significant attention to the area of testimonials because it relates to the problem of unproven remedies (Roth, Tr. 1610). Thompson's expert, Dr. O'Brien, acknowledged that the Arthritis Foundation is a reliable source of information about the treatment of arthritis and the scientific issues surrounding the disease, and that the Foundation takes the position that testimonials and **[103]** case histories cannot be relied on to show that a remedy works for the diseases of rheumatoid arthritis and osteoarthritis (O'Brien, Tr. 3919–20, 3925). The reason the Foundation takes this position as regards case histories is because arthritis has peaks and valleys and may go away by itself just when a person tries a new remedy (O'Brien, Tr. 3926). For this reason, the Foundation takes the position that controlled trials of drugs and remedies are employed to determine safety and efficacy while discounting the placebo effect and other sources of bias. Such controlled clinical trials are acceptable as scientific proof (*Id.*).

343. The unreliability of Thompson's testimonial evidence is evident from a sampling of the testimonial letters it received. For example, one letter is from a chiropractor who used Aspercreme on himself and thought it was good. He also indicated that he was using it on his patients in conjunction with ultrasound treatment. Reports such as these do not constitute valid scientific evidence (Adriani, Tr. 1232; Roth, Tr. 1611–12). Another letter stated that Aspercreme was effective in a case of stroke paralysis. There is no topically-applied medication that would be efficacious for stroke victims, and this type of testimonial may be aptly compared to faith healing (Adriani, Tr. 1233; Roth, Tr. 1612). Still another letter submitted by Thompson as substantiation for its claims is a "Dear Doctor" promotional letter sent out by another pharmaceutical company, B.F. Ascher & Co., to physicians introducing a new oral product for arthritis treatment (Adriani, Tr. 1234–35). The letter discusses a topically-applied TEA/S cream as an adjunct to oral therapy for arthritis. This document does not constitute proof of Aspercreme's efficacy (Adriani, Tr. 1235; Roth, Tr. 1612–13).

I. *Drug Compendia And General Scientific Literature As Proof Of Drug Efficacy*

344. Thompson has also relied on the inclusion of TEA/S in certain compendia of drug products as an indication of Aspercreme's drug

efficacy. However, TEA/S is not included in any of the authoritative reference works on drugs. The publications in which TEA/S is listed are listings of marketed drugs. Importantly, there are only a few published reports on TEA/S in the medical or scientific literature.

345. For example, there are no listings for Aspercreme or TEA/S in four of the most authoritative drug compendia: the *U.S. Pharmacopoeia* (O'Brien, Tr. 3716; Silverman, Tr. 2384; Steinberg, Tr. 5229); the *National Formulary* (O'Brien, Tr. 3716; **[104]** Silverman, Tr. 2386); *Remington's;* and Goodman and Gilman's book, *The Pharmacological Basis of Therapeutics* (O'Brien, Tr. 3718; Steinberg, Tr. 5227–29). The omission of TEA/S products from these standard reference works is significant. A drug has to be recognized as efficacious in order to be listed in the *U.S. Pharmacopoeia,* an official standard reference work (Silverman, Tr. 2378–79, 2387). *Remington's* is also considered to be an authoritative treatise on drugs, while Goodman and Gilman's book is widely regarded as a major reference work on drug efficacy and drug action (Steinberg, Tr. 5227). Dr. Steinberg of Thompson was well aware that a number of authoritative United States treatises did not include TEA/S (Steinberg, Tr. 5229). And Dr. Silverman, Thompson's pharmaceutical expert, agreed that in CX 393, the FDA Panel on OTC Skin Protectant Products for Human Use, only drugs that were listed in standard texts were placed in Category 1 absent clinical trials (Silverman, Tr. 2391–94).

346. Aspercreme is listed in the *Handbook of Nonprescription Drugs.* Dr. O'Brien, an expert witness for Thompson, acknowledged that he would not rely on the *Handbook* to determine whether or not an analgesic product is effective (O'Brien, Tr. 3903). Dr. Silverman conceded that the sixth edition of the *Handbook of Nonprescription Drugs* repeats the findings of the FDA Panel on OTC External Analgesic Products about TEA/S (Silverman, Tr. 2420–21).

347. Aspercreme is also listed in the *Physicians' Desk Reference on Nonprescription Drugs.* Dr. O'Brien agreed that the Physicians' Desk Reference ("PDR") is not an authoritative source of drug information. Typically, much of the book consists of excerpts from package inserts and no one would look to it as an academic source of information (O'Brien, Tr. 3905).

348. Three other books in which TEA/S products are listed, namely the *American Drug Index, Facts and Comparisons,* and Perry's *Prescription and Nonprescription Drugs,* are all-inclusive indexes or lists which purport to include all drugs marketed in the United States (Silverman, Tr. 2379, 2384; Steinberg, Tr. 5226). Neither the *American Drug Index* nor *Facts and Comparisons* are compendia in the sense that the *U.S. Pharmacopoeia* is (Silverman, Tr. 2378–79, 2381–

82). Unlike the *U.S. Pharmacopoeia*, they do not constitute official standard reference works on drugs (Silverman, Tr. 2378–79).

349. With respect to published reports about TEA/S in the medical/scientific literature, Thompson's expert witness Dr. Silverman testified that although he conducts a literature search specifically on TEA/S twice a year, he has never seen any articles recommending its use as an analgesic other than those **[105]** written by Drs. Golden (RX 48/CX 200) and Rabinowitz (RX 70/CX 374) (Silverman, Tr. 2347). Dr. Adriani testified that he was not aware of published reports in the literature about TEA/S (Adriani, Tr. 1434). And Dr. Roth indicated that prior to his participation in the instant case, he had never seen anything on TEA/S in the medical literature. Dr. Roth also testified that he had never heard of TEA/S being the subject of a paper at a professional meeting (Roth, Tr. 1761).

J. *The Pharmacology of Triethanolamine Salicylate (TEA/S) And Its Mechanism Of Action*

350. Much of the record information pertaining to the pharmacology and mechanism of action of TEA/S is based on the testimony of Dr. Silverman, Thompson's pharmaceutical expert witness. Respondent's theory, as further elaborated in this case, is essentially that Aspercreme delivers salicylate molecules to the subcutaneous tissues by direct penetration of the skin, and provides pain relief in the site of pain by inhibiting prostaglandin synthesis in the cell (CX 45N (Admission No. 274)). Although Dr. Silverman's testimony in this regard was not directly contradicted or rebutted by other expert testimony, the record is clear that Dr. Silverman's hypothesis is a novel one and was expounded publicly for the first time in this proceeding. The Silverman hypothesis remains to be accepted by the medical scientific community. It also leaves too many important questions unanswered and is inconsistent in some important respects. In any event, theories regarding a drug's mechanism of action are important and useful but they are not substitutes for well-controlled clinicals for the purposes of showing drug efficacy.

351. The active ingredient of Aspercreme is triethanolamine salicylate (TEA/S). TEA//S is manufactured by combining equal amounts of triethanolamine and salicylic acid. The resulting compound has a relatively low molecular weight of 280 (Silverman, Tr. 2113). According to Thompson's pharmaceutical expert, this low molecular weight helps the TEA/S molecule to be absorbed through the skin (Silverman, Tr. 2114). Radioisotope testing and bioavailability studies in this record have suggested that some topically applied drugs can penetrate the skin.

352. The human skin is constructed of several layers of cells. There

are five layers on the stratum corneum and two on the diadermis. Even though the cellular layers are differentiated in function, they have one common characteristic: [106] they consist of cells which have a cell membrane on the outside and protoplasm on the inside. The cell membrane consists of both lipid (fat) and water, *i.e.,* the cell is phospholipid (Silverman, Tr. 2140–41). Thus, for a drug to pass through the cell membrane, it needs to have both water solubility and lipid solubility (Silverman, Tr. 2117, 2141). According to Dr. Silverman, TEA/S has very good water solubility and some lipid solubility (Silverman, Tr. 2115). Molecules which have a solubility ratio of one to one, *i.e.,* 50% in water and 50% in lipid, have the best ability to penetrate the biological cell membrane. According to Dr. Silverman, TEA/S has 60/40 solubility ratio (60% in water and 40% in lipid) and penetrates the cell membrane well (Silverman, Tr. 2118).

353. The outer layer of the skin consists of a dead layer of dry cells. According to Dr. Silverman, when Aspercreme is applied, these dry cells are hydrated by the oil in the product, and penetration is facilitated. According to respondent's experts, the TEA/S molecule dissociates into a triethanolamine ("TEA") molecule and a salicylate ("SA") molecule in the presence of water (O'Brien, Tr. 3938; Silverman, Tr. 2125; RX 1013). This fact can be demonstrated by either of two tests: a Beckman thermometer test (which measures temperature differences between a freezing point of the molecule and a freezing point of the dissociated mix) or an osmometer test (which measures the rapidity and depth of electrical signals to determine how many particles are in solution (Silverman, Tr. 2125–26). Dr. Silverman hypothesized as follows: when Aspercreme is placed on the skin, the waxes in the product's vehicle (triethanolamine) soften the dry outer layers of the skin creating an occlusive effect which hampers the evaporation of water from the skin (Silverman, Tr. 2146), the TEA/S molecule starts to dissociate or ionize into its components, a TEA ion and a SA ion, and TEA and SA ions are very water soluble and will pass through the skin slowly (Silverman, Tr. 2127–28, 2146–47). According to the Silverman hypothesis, in addition to ionization, another chemical process, hydrolysis, is taking place. As the TEA ion comes in contact with water in the skin, the TEA ion reacts with the hydroxyl ion of water (*i.e.,* $-OH$) and reverts back to the TEA molecule. The TEA molecule, which has biphasic solubility (solubility in both water and lipid), penetrates the skin (Silverman, Tr. 2128–29). As the SA ion comes in contact with the water in skin, the SA ion reacts with the hydrogen ion of water (*i.e.,* $H+$) to form salicylic acid. According to Dr. Silverman, the salicylic acid molecule has good lipid solubility with some degree of water solubility and penetrates through the skin. Thus, when the TEA/S molecule is applied to the skin, chemical

reactions called ionization and hydrolysis occur so that the TEA/S molecule dissociates and recombines as needed to pass through the membranes. These [107] reactions establish a constant topical reservoir in equilibrium that provides TEA molecules and SA molecules which penetrate the skin and gradually migrate through the epidermis and diadermis to the underlying tissues of the body (Silverman, Tr. 2132–34, 2136–37, 2146–47). Migration is possible because the outer membrane of the cell wall is phospholipid, (*i.e.,* both lipid and water in nature), while the interior of the cell is largely protoplasm with inorganic salts (and hence largely water in nature). Penetration of a cell by the molecule involves movement through the lipid barrier of the cell membrane and movement through the water barrier inside the cell (Silverman, Tr. 2150). According to Dr. Silverman, because the TEA/S molecule has both water and lipid solubility, it will "percolate" its way through the various layers of the skin, connective tissues, and muscles to the bone (Silverman, Tr. 2152–54, 2165).

354. Penetration of a drug through the skin is enhanced if a drug is soluble in both water and lipid and if it has a molecular weight of less than 1,000 (Adriani, Tr. 1294; CX 269, p. 69,774). Penetration through the skin is also enhanced if the skin is damaged (Adriani, Tr. 1291–92; CX 269, p. 69,774). Damaged skin is skin in which the stratum corneum remains intact, but there is edema (fluid retention), inflammation, or other pathological processes present in the lower layers of the skin as a result of an injury or a disease (Adriani, Tr. 1293; CX 269, p. 69,773). According to Dr. Silverman, where there is inflammation present, as there is in arthritis or rheumatism, penetration is increased (Silverman, Tr. 2167, 2169). And drug absorption is further facilitated if the substance is rubbed or massaged into the affected area (Adriani, Tr. 1295; Silverman, Tr. 2169, 2176).

355. Inflammation is characterized by heat, redness, swelling, and tenderness in the affected tissues (CX 269, pp. 69,777–78). The salicylate ion exerts an anti-inflammatory effect (Roth, Tr. 1658; Silverman, Tr. 2486–87; CX 269, p. 69,778). It has generally been hypothesized of late that the salicylate ion achieves this anti-inflammatory effect by interfering with the biosynthesis of prostaglandins (PGs) at the cellular level. Prostaglandins are complex, hormone-like molecules which are synthesized from arachidonic acid which is present in the body. Prostaglandins E_1 and F_2 have been shown to be capable of producing local inflammation. Trauma to the body causes the cells to produce PGs. PGs E_1 and F_2 cause pain and inflammation by intensifying the pain producing properties of certain compounds within the body (Stipulated testimony of Dr. Ehrlich with respect to medical literature, Tr. 4006; RXs 1014–15). Thus, in theory aspirin and other salicylates can be useful in interfering with the develop-

ment of [108] prostaglandins from arachidonic acid (Ehrlich, Tr. 4005; CX 269, pp. 69,777-78; RX 1015).

356. Respondent's medical experts testified that Aspercreme, through its TEA/S component, achieves its analgesic and anti-inflammatory action by penetrating through the skin to the underlying tissues and working at a cellular level, through its salicylate ion, to inhibit the formation of PGs (Ehrlich, Tr. 4008-09; Heller, Tr. 2612-13).

357. It is difficult if not impossible to determine at what blood (serum) level the salicylate ion becomes an effective analgesic agent. The amount of salicylate in the blood does not correlate to clinical analgesia (Adriani, Tr. 1290; CX 268, p. 35,382).

358. Therapeutic serum levels of salicylate differ from the levels of salicylate at the local site (Roth, Tr. 1688). Therefore, the pain-relieving effectiveness of an analgesic agent cannot be measured by analysis of the salicylate serum level (Roth, Tr. 1688). According to Dr. Silverman, because aspirin is ingested orally and must first circulate through the blood stream before reaching the affected site, the action of oral aspirin in relieving pain is slower than the action of topically applied salicylate (Silverman, Tr. 2174; RX 49).

359. Theories regarding a drug's mechanism of action are not a substitute for clinical testing for purposes of demonstrating drug efficacy. Thus, attempts to evaluate a drug's mechanism of action are generally made after the drug's efficacy has been established clinically (Ehrlich, Tr. 4008-10; Roth, Tr. 1613-15). In any event, even on a purely theoretical basis Thompson's theories of Aspercreme's action leave too many questions unanswered. The record also shows many inconsistencies with respect to the assumptions about salicylates, TEA/S, and prostaglandins upon which the theories essentially rest.

360. As to salicylates, the Thompson's theory apparently is founded on the tenet that topical TEA/S arrives in the muscle or other point of pain as salicylate and that the salicylate in TEA/S is the same as the salicylate in aspirin and will therefore provide relief in the same way as oral aspirin does (Steinberg, Tr. 5131). Aspirin and TEA/S are not the same drug: aspirin is a salicylate to which an acetyl group has been added; TEA/S is a milder nonacetylated salicylate (O'Brien, Tr. 3729, 3877-78; Roth, Tr. 1516-17). The assumption that all salicylates are the same is untenable given that no one really knows how analgesics work and that the metabolism of aspirin in the body is highly complex (Ehrlich, Tr. 4047-48; O'Brien, [109] Tr. 3877). Currently, there are at least two schools of thought on aspirin's action. One is that the salicylate molecule itself is anti-inflammatory, and that the acetyl moiety is merely a means of delivering the salicylate. The other is that the acetylation irreversibly acetylates the platelets that are

part of the inflammatory process and this is essential for full relief (O'Brien, Tr. 3879; Roth, Tr. 1658–59). Moreover, there is a body of opinion to the effect that nonacetylated salicylates do not inhibit prostaglandin synthetase (Roth, Tr. 1675). Regardless of how either aspirin or TEA/S may work, there is also support for the proposition that aspirin and salicylates other than methyl salicylate are not effective as *topical* analgesics (Adriani, Tr. 1480).

361. Disregarding the chemical differences between TEA/S and aspirin, there are still unanswered questions surrounding the "site of action" component of Thompson's theory. Although theories as to how aspirin works are continuously evolving, the prevailing view is that in producing an analgesic effect, aspirin acts peripherally, or locally, as well as centrally on the central nervous system (Ehrlich, Tr. 4057–58; Roth, Tr. 1655–56; CX 268, pp. 35,351, 35,381). When Thompson acquired Aspercreme from Sperti in 1976, there were two theories about Aspercreme's mechanism of action. One was that topical TEA/S exerted an analgesic effect by achieving therapeutic levels in the bloodstream. The other was that TEA/S worked by penetrating directly to the point of pain (Steinberg, Tr. 5261–62; RX 41/CX 251Z–058). For purposes of this proceeding, Thompson has adopted the position that topically applied TEA/S acts locally "at the point of pain" (CX 45N (Admission No. 274)). Topical TEA/S, unlike aspirin, is not a systemic drug and thus would not provide whatever relief is produced by the central nervous system ("CNS") effect of aspirin. In addition, TEA/S could do little to modify a systemic process like inflammation, which is a major factor in many arthritic conditions (Roth, Tr. 1536, 1757).

362. In addition, TEA/S is a relatively obscure drug. There is little medical literature on TEA/S, and it is not included in any authoritative drug treatise (O'Brien, Tr. 3716–18; Roth, Tr. 1761; Silverman, Tr. 2347, 2385–86). An expert advisory panel to the FDA has approved TEA/S, in concentrations of 5% to 12%, as an OTC drug for only one use, as a mild sunscreen (Roth, Tr. 1684; CX 394B, H). It is the salicylate, not the TEA, in TEA/S that acts as a sunscreen (Roth, Tr. 1684; CX 394B (triethanolamine salicylate listed as an active sunscreen ingredient, triethanolamine listed as inactive)). This would suggest that most of the salicylate in TEA/S remains in the dermis, rather than penetrating into the deeper tissues, [110] since all sunscreens work in this fashion (Adriani, Tr. 1458; Roth, Tr. 1684).

363. Another problem in Thompson's theory of Aspercreme's efficacy is the assumption that TEA/S works by inhibiting prostaglandin synthetase. Prostaglandins are enzymes found throughout the body, some of which are now thought to be implicated in the inflammatory process (Adriani, Tr. 1286–87; Roth, Tr. 1651–52). However, there is

no evidence in this proceeding showing that TEA/S blocks prostaglandin synthetase. Moreover, blocking prostaglandin formation is not the only way of curbing the inflammatory process, since several mechanisms are known to be involved in inflammation (Ehrlich, Tr. 4049–51; Roth, Tr. 1745–46). Furthermore, prostaglandin theory is an evolving theory and not all prostaglandins have been discovered. Some known prostaglandins, which were initially thought to play a central role in the inflammatory process, are now considered to be less important as new prostaglandins are discovered (Ehrlich, Tr. 4049–50; Roth, Tr. 1755–57). In addition, no one knows which prostaglandins are involved in arthritis (Adriani, Tr. 1445; Ehrlich, Tr. 3996–97). Finally, prostaglandins are only one of a series of inflammatory mechanisms studied over the years (Roth, Tr. 1613–15). In any event, the requirement for well-controlled clinical trials remain unaffected by any theory of the inflammatory process (Adriani, Tr. 1446; Ehrlich, Tr. 4008–10; Roth, Tr. 1624).

364. From all of the foregoing, it is found that Thompson's clinical trials, bioavailability studies, and theories about TEA/S' mechanism of action fail to provide an acceptable level of scientific support for the claim that Aspercreme acts by penetrating through the skin to the site of arthritic disorders. On the contrary, the failure to show significant bioactivity in controlled clinicals suggests that TEA/S in Aspercreme is not absorbed in amounts necessary to demonstrate its analgesic efficacy (Roth, Tr. 1574).

K. *Marketing Data Related To Aspercreme*

365. In support of its claims of Aspercreme's efficacy, Thompson relies on various marketing-related data, including Aspercreme package insert cards mailed in by purchasers of the product, a survey of pharmacists, information on repeat purchases, and unsolicited consumer letters received over the years. According to the FDA Panel Report on External Analgesic Products, as well as expert opinion in this case, marketing experience related to an OTC analgesic product is at best a corroborative or confirmatory type of evidence, and under the [111] prevailing, scientifically accepted principles, it does not constitute the direct evidence or primary evidence needed to prove drug efficacy in the first instance (Adriani, Tr. 1433–34; Ehrlich, Tr. 4155–56; Roth, Tr. 1764; CX 269, p. 69,780). The FDA regulations governing the advisory panel OTC drug review process specifically provides that reports of significant marketing experience are appropriate only as a source of corroboration for proof of effectiveness, and that isolated case reports, random experiences, and reports of product efficacy lacking the details which permit scientific evaluation are not to be relied on in determining product effectiveness. 21 C.F.R.

330.10(a)(4)(ii). Therefore, marketing experience by itself cannot be regarded as constituting adequate proof of drug efficacy (CX 395B).

366. Marketing data includes information on the number of units of the product sold to consumers and the number of consumer complaints received by the manufacturer (Adriani, Tr. 1346–47). Marketing data can indicate wide consumer acceptance of a drug (Adriani, Tr. 1345). And while not a primary source of information on a drug's efficacy (Roth, Tr. 1704), postmarketing data can provide a level of important information related to product safety—primarily long-term toxicity and idiosyncratic reactions resulting from product usage (Roth, Tr. 1709–10).

1. Consumer Response Cards And Consumer Letters

367. Evidence relied on by Thompson includes various data showing consumer satisfaction with the product, such as the following:

(i) Consumer response cards (package insert cards): Beginning in 1978, Thompson Medical included response cards in Aspercreme packages which were to be filled out and returned by the user. While there have been various forms of response cards which asked somewhat different questions, consumers were generally asked their general opinion of Aspercreme, particularly whether it worked better than aspirin. By 1982, some 30,000 response cards had been returned to Thompson. Two different tabulations of various groups of response cards were prepared. The results generally indicated that the consumers who returned the response cards had a favorable opinion towards Aspercreme (RXs 292, 521, 711). [112]

(ii) Consumer letters: When Thompson acquired Aspercreme from the Sperti Drug Company in 1976, all consumer letters which had been received by Sperti were turned over to Thompson (Siegal, Tr. 4599). Since then, Thompson has continued to receive consumer letters regarding Aspercreme (Siegal, Tr. 4598–99). Currently, Thompson's file of consumer letters contains almost 800 letters, most of which comment favorably on Aspercreme's efficacy (Siegal, Tr. 4603–04).

(iii) Thompson Medical has received approximately 3,400 requests for refunds since 1978 (RX 94).

368. The consumer response cards and letters represent only a small fraction (about 2%) of the Aspercreme purchases (Siegal, Tr. 4666; Silver, Tr. 5884, 5886). Such a low response rate is considered unacceptable for a survey because the respondents could not be considered representative in any meaningful sense (*See* Silver, Tr. 5883–84). This is particularly true with respect to the response cards and letters because, unlike a survey, these consumers were completely

self-selected. It is also clear that those who sent in the response cards and letters differ substantially from those who did not in that the former feel much more strongly about Aspercreme than the latter (Ross, Tr. 6449–50).

2. *Pharmacy Times* Survey (RX 143)

369. RX 143, "OTC Products The Pharmacist Recommends And Why," is a 1981 survey of pharmacists by *The Pharmacy Times*, offered to support Aspercreme's efficacy claims. *The Pharmacy Times* is a marketing publication for the pharmacy trade and is distributed free of charge to pharmacists and pharmaceutical houses. Its costs are borne by its advertisers. *The Pharmacy Times* purports to provide marketing information in the field of pharmacy (Reis, Tr. 5488). *The Pharmacy Times* survey of OTC drug products is conducted on an alternate year basis (Reis, Tr. 5492). RX 143, the report of the results of the survey, was first published in *The Pharmacy Times* in approximately late spring of 1981 (Reis, Tr. 5493). The survey was conducted by mailing questionnaires to a selected group from among the retail trade portion of *The Pharmacy Times'* mailing list (Reis, Tr. 5493–94). The survey questionnaires were mailed concurrently with a request for verification of address, as part [113] of *The Pharmacy Times'* audit of circulation conducted once every three years (Reis, Tr. 5495, 5498–99). A total of 3,000 questionnaires were mailed out, and there were some 807 completed returns at the time the report was prepared (RX 143C). The survey questionnaire first asked respondents to estimate the number of recommendations they or their employees make for all brand name products in each category of OTC products each month. Secondly, the questionnaire asked which single product within each category the respondent would recommend by brand name (Reis, Tr. 5511–12; RX 143).

370. *The Pharmacy Times* survey is thus essentially a marketing survey. The results show that only 11.5% of the respondents recommended Aspercreme, and about 70% of the respondents made no recommendations for topical analgesics or did not recommend a TEA/S-based product (RX 143). In any event, pharmacists' recommendations are substantially influenced by advertising and other promotional activities (Ross, Tr. 5541, 6404–05). Studies in the literature have demonstrated the influence of advertising on physicians and dentists (Ross, Tr. 6405). The effect of advertising on consumer experience has been noted by FDA expert advisory panels (*See, e.g.*, CX 396B). In the present case, Thompson's trade ads, such as RX 166E (a trade ad to druggists), made strong express claims that Aspercreme's effectiveness was clinically proven, and proven better than aspirin in clinical studies (Ross, Tr. 6406–07). Dr. Roth testified that a survey of

pharmacist recommendations of pain relief products is not reliable evidence that the product in fact relieves pain (Roth, Tr. 1706–07). Dr. O'Brien testified that he does not rely on retail pharmacists as a source of information on the efficacy of OTC drug products (O'Brien, Tr. 3906–07). Since pharmacists' recommendations are based on a number of factors other than product efficacy, they do not provide reliable evidence of the efficacy of Aspercreme. The survey (RX 143) also suffers from a number of methodological problems (*See* CPF 435–38). It is of little value in this proceeding.

371. In any event, the 1981 *Pharmacy Times* survey (RX 143) was not published until late spring of 1981 (Reis, Tr. 5493). Thompson did not possess and rely on RX 143 when those advertising claims were made (*See* CX 25), nor did it cite or rely on this survey as part of its reasonable basis materials (*See* CX 44A).

L. *The Significance of Other Clinical Trials Showing Negative Results For 10% TEA/S Topical Products*

372. Just as the clinical trials which failed to show significant differences between TEA/S and aspirin do not prove [114] that the two are equally effective (F. 237, *supra*), the five other clinical studies in evidence which compared TEA/S and placebo with negative results do not prove that there is no difference between the two. These negative studies simply show that the analgesic efficacy of TEA/S remains to be established. The five studies are the Roth study (CX 344Z–195); Ehrlich study (CX 344Z–157); Charles study (CX 344Z–168); Brown study (CX 344Z–182); and Algozzine study (CX 255). All of the five tested a 10% TEA/S creme as an adjunctive drug to be used in conjunction with other therapy (Adriani, Tr. 1454).

373. The first four studies (CX 344 series) had been submitted by Warren-Teed Pharmaceuticals Corporation, the marketer of Myoflex (a 10% TEA/S rub), to the FDA in connection with the FDA's monograph proceeding involving OTC external analgesic drug products (CX 344A). In its Tentative Final Monograph on OTC External Analgesic Products, published February 8, 1983, the FDA referred to the four studies and stated that none of them reported any significant differences between TEA/S and placebo for any of the measurements recorded (CX 443D).

374. While some of these negative studies have been criticized as not being well-controlled in several respects, these studies, together with the other studies discussed earlier (*i.e.*, the Golden study, the Golden and Altschuler study, the French studies and the Batterman and Sanders study) show the many opportunities that TEA/S has had—with different methodologies, by different investigators, and under

various conditions—to show that it is significantly better than placebo (Roth, Tr. 1622–23).

375. The five negative studies discussed here which tested TEA/S as an adjunctive drug also show that Aspercreme's efficacy when used to relieve the so-called breakthrough pain (*See* RPFs 138 and 140) remains to be demonstrated (Adriani, Tr. 1454–55). In any event, the evidence regarding the five so-called negative clinicals is summarized below.

1. The Roth Study (CX 344Z–195)

376. The first study, entitled *Myoflex Arthritis Study* (CX 344Z–195), by Dr. Sanford Roth, was a double-blind, two-way crossover study which compared the effects of Myoflex cream and a placebo cream in arthritis patients. One hundred and two patients were enrolled in the study, which took from July 1976 to November 1978 to complete (Roth, Tr. 1521). Efficacy measures in the study included the average daily duration of morning stiffness; average joint size in both hands; grip strength in both hands; an articular index with categories for **[115]** pain, swelling, and limitation of movement; a nine-point scale showing the patient's overall assessment of pain; and a composite articular index. Observations on each of these variables were taken at baseline and at the end of the first and fourth weeks of each treatment sequence. In addition, a treatment preference rating was obtained from the subjects at the end of the second treatment sequence. The study results shows that in comparing the two creams on ten objective efficacy parameters and on the subjective parameter of patient treatment preference, there were no statistically significant differences between Myoflex cream and placebo cream (Roth, Tr. 1518–21, 1524–25; CX 344Z–200–04).

377. The subjects in the Roth study were patients with diagnosed chronic rheumatoid arthritis. The study design provided that the subjects could continue to use, as concomitant medications on an as needed basis, those oral anti-inflammatory and/or analgesic agents that they had been using prior to their participation in the study (CX 344Z–197–98). The reason for this was that rheumatoid arthritis is a systemic disease and since there was no evidence that the topically applied agent had any systemic effect, the existing forms of systemic therapy were continued to provide a baseline. The topically applied creams were being added on to the patients' regimens as a layer of further treatment to see if the test ingredient made an extra difference in controlling the pain symptom (Roth, Tr. 1752). By crossover of the test and control substances in a double-blind manner, each of the patients acted as his own control (Roth, Tr. 1552). There were no major changes in the subjects' regimens during the study period

(Roth, Tr. 1523). An additional reason for the subjects' continuing their systemic medications during the study period was that the TEA/S product tested in the Roth study, Myoflex, was intended for use as an adjunct to other treatment and was in fact marketed as an adjunctive product. Where the tested product is so marketed, it would be inappropriate to take study subjects off their concomitant medications (Roth, Tr. 1524).

378. In the Roth study, many subjects suffering from moderate to severe osteoarthritis did not get any relief from aspirin despite the fact that therapeutic doses of aspirin have been proven effective in treating moderate osteoarthritis (Roth, Tr. 1714–15). Dr. Adriani also noted that the use of oral anti-inflammatory or analgesic drugs and the use of physical therapy during the test period made the results unreliable as evidence of Myoflex's analgesic efficacy.

379. The Roth study finding that TEA/S is indistinguishable from placebo was one of those cited in the Tentative Final Monograph on OTC External Analgesic Drug Products as a basis for the FDA's conclusion that the evidence does not support Category I status for TEA/S as an OTC external analgesic **[116]** (CX 443D). In a letter to the manufacturer of Myoflex (CX 343C), the FDA's Bureau of Drugs likewise referred to the Roth study in reaching a similar conclusion.

2. The Ehrlich Study (CX 344Z–157)

380. The second clinical study, entitled *Myoflex Creme in Patients With Chronic Musculoskeletal Complaints* (CX 344Z–157), by Dr. George Ehrlich (one of Thompson's expert witnesses in this case), was a double-blind, placebo-controlled, crossover evaluation of a TEA/S cream and a placebo cream. The fifteen study subjects applied the TEA/S cream or placebo cream to the affected area three times daily for two two-week test periods. The objective of the study was to evaluate the analgesic effectiveness of Myoflex cream in the treatment of prolonged or chronic disability of musculoskeletal origin. Patients with arthritic symptoms, with sporadic musculoskeletal complaints, or with histories of spontaneous remission were excluded from participation in the study (CX 344Z–158).

381. The Ehrlich study was originally scheduled to have thirty subjects, but the investigator was unable to secure sufficient patients with the specified qualifications within a reasonable period of time and a decision was made to terminate the study at fifteen patients. This number is obviously inadequate (F. 232, *supra*). Of the fifteen patients, two did not complete both study periods and thus their results were excluded from the final evaluations. Physical therapy programs and oral anti-inflammatory drugs used by the subjects prior to entering the study were normally maintained. Ten of the subjects

were using a concomitant medication during the study period. This was in keeping with the usage and marketing of Myoflex creme as an adjunct analgesic product. No oral or other typical salicylates were permitted during the study (CX 344–158–59).

382. The study results showed that Myoflex provided some pain relief to six of the thirteen patients completing the study, while four of the thirteen patients reported some relief from use of the placebo cream. The degree of pain relief provided by Myoflex did not appear to be significantly greater than the degree of relief provided by the placebo. For the parameters of onset of pain relief and duration of relief, the differences between Myoflex and placebo were small and probably not significant. In terms of increased strength in the affected area, the improvement with Myoflex was not significantly different from that of placebo. In all, there were no statistically significant differences between active drug and placebo for any of the measurements recorded. [117]

3. The Charles Study (CX 344Z–168)

383. The third study by Dr. Alix A. Charles, entitled *Myoflex Creme in the Treatment of Chronic Musculoskeletal Complaints,* had the same basic design as the Ehrlich study. Like the Ehrlich study, it was criticized for inadequate sample size, use of concomitant physical therapy and the maintenance of drug therapy in many of the subjects (Adriani, Tr. 1411–14; Roth, Tr. 1621).

384. Out of a total of thirty subjects planned for inclusion in the Charles study, twenty-six patients entered the study, but final data is available for only twenty who completed the full study regimen. Of these, twelve continued their prior use of physical therapy and/or concomitant medication during the study period, again reflecting the intended use of Myoflex cream as an adjunctive product. The study showed that Myoflex provided some pain relief in fifteen of the twenty patients who completed the study. However, an equal number of patients reported relief from the placebo agent. Relief, as measured by improvement from the initial pain, was statistically significant for both treatments, but there were no significant differences between Myoflex and placebo for any of the parameters studied. The study write-up noted that the high placebo response rate observed in the study was not unusual for analgesic type studies. Both treatments required the topical cream to be rubbed into the affected area, it noted, and this massage action itself may be beneficial to patients with musculoskeletal complaints.

4. The Brown Study (CX 344Z–182)

385. The fourth clinical trial is entitled *Myoflex/Chronic Musculoskeletal Complaints* (CX 344Z–182). It was conducted by Dr. Burnell Brown for Adria Laboratories, manufacturer of Myoflex. The objective of the Brown study was to evaluate the efficacy of Myoflex in the adjunctive relief of pain associated with chronic musculoskeletal complaints. The study included fifty-two patients (of whom forty-two completed the full study regimen) in a double-blind, matched placebo controlled, crossover evaluation. The subjects were assigned to the test groups randomly, with half the subjects starting with Myoflex and half with placebo the first week, before being switched to the crossover medication for an additional one week. After the two one-week periods with TEA/S and placebo (without washout between periods), all patients were treated for a final one-week period with methyl salicylate. Statistical analysis of the data for the forty-two evaluable patients in the Brown study revealed [118] no statistically significant differences between the Myoflex, placebo, or methyl salicylate treatments based on any of the four study parameters analyzed: reduction of pain; increase in mobility; reduction in muscle tenderness; and overall musculoskeletal complaint improvement (CX 344Z–187). The Brown results are questionable because of the use of oral anti-inflammatory agents and failure to distinguish different clinical entities and diseases (Adriani, Tr. 1414–15; CX 344Z–182). Dr. Roth testified that the Brown study's methodology was flawed and that it did not measure up to the criteria for a valid study (Roth, Tr. 1719).

5. The Algozzine Study (CX 255)

386. The most recent of the five clinical studies in which TEA/S was reported to be no more effective than placebo is the study entitled *Trolamine Salicylate Cream in Osteoarthritis of the Knee* (CX 255), by Dr. Gary Algozzine, *et al.*, reported in the March 5, 1982 issue of the *Journal of the American Medical Association.* The study involved twenty-five patients, drawn from a Veteran's Administration hospital in Florida, who had symptomatic osteoarthritis of the knee. Study subjects were asked to designate their most painful knee and to apply either 10% TEA/S or placebo cream four times daily for two one-week periods in a randomized double-blind crossover study. Drug efficacy was measured along both subjective and objective parameters.

387. Patients were prohibited from using any concomitant oral or topical salicylates or any other analgesic drug during the study period and for the two days preceding the test period. However, because TEA/S was considered adjunctive treatment, patients currently re-

ceiving other forms of drug treatment for osteoarthritis (*e.g.*, non-steroidal anti-inflammatory agents) were eligible for inclusion in the study provided that their condition had been stabilized on a stated dose of the drug for the preceding one-month period. There were no changes in drug or dosage permitted during the study period. No patient received an intra-articular injection of a corticosteroid within the preceding six weeks, and no other form of treatment, such as external heat, exercise, or massage was used during the study period. Thirteen patients received concomitant non-steroidal anti-inflammatory medication during the study period.

388. The study results showed no statistically significant difference either in subjective or objective measures of relief between the treatment and control groups. Eight patients preferred the "active" test cream, while six preferred placebo, and eleven had no preference (CX 255B). The investigator **[119]** concluded that the clinical data show the total effect of 10% TEA/S cream to be no better than that of placebo (CX 255C). In any event, this study suffers from a few defects. More than half of the test subjects received concomitant non-steroidal anti-inflammatory agents (Adriani, Tr. 1419), and they were virtually all bedridden males in a VA hospital, a group not well suited for the trial of a topical drug intended for minor pain of arthritis.

389. The presence of conflicting evidence with respect to a drug's efficacy leaves the scientific community in doubt about the drug's efficacy, as respondent's own expert acknowledged (O'Brien, Tr. 3738). Dr. Steinberg, an officer and employee of Thompson, testified that in and around 1980, he became aware of the four TEA/S studies conducted by Drs. Roth, Ehrlich, Charles and Brown (Steinberg, Tr. 5255). He became aware of the Algozzine study when it was published in the *Journal of the American Medical Association* in 1982 (*Id.*). Despite this information, the company continued to make its unqualified efficacy claims for Aspercreme.

M. *The Argument That The Evidence Of Perceived Benefits Constitutes Adequate Substantiation For Aspercreme Efficacy Claims*

390. Respondent vigorously contends that Aspercreme has been shown to be a safe topical drug capable of providing perceptible pain relief to a significant segment of the consuming public and that this evidence alone is sufficient to satisfy the Commission's reasonable basis requirement. In this connection, respondent points to the fact that a number of FDA OTC drug panels, including the OTC External Analgesic Products Panel, have determined a number of ingredients to be effective on the basis of uncontrolled studies, long-term clinical use and marketing experience. Respondent urges that Aspercreme

should be found effective on the same basis (*See* RPF 123, 206–28; RB 49–59). These arguments, however, cannot be reconciled with the consistent refusal of both the FDA and its External Analgesic Panel to find TEA/S to be effective for labeling/marketing purposes (F. 393–95, *infra*).

391. The FDA OTC drug panels which based a finding of drug efficacy on evidence short of two well-controlled clinical trials include the OTC Internal Analgesics Panel:

(a) The Panel found, without well-controlled studies, the ingredient choline salicylate to be an effective analgesic. The Panel based its findings **[120]** solely on a survey of physicians who had given the ingredient to their patients. In some cases, the physician compared the effects of choline salicylate in some patients with the known effects of aspirin in his patient population at large (CX 268, p. 35,418).

(b) The Panel found the ingredient magnesium salicylate to be an effective analgesic. The Panel relied upon a clinical study with only twenty-two patients which compared magnesium salicylate with aspirin and found no statistically significant differences in the levels of analgesia. Because magnesium salicylate produced less gastrointestinal irritation than aspirin, the authors of the study concluded, and the Panel agreed, that magnesium salicylate was not only an effective analgesic, but preferable to aspirin for conditions requiring long-term therapy (CX 268, p. 35,419).

(c) The Panel found calcium carbaspirin to be an effective antipyretic, not based on controlled clinical studies, but on the fact that the absorbed moiety is aspirin and its established adequate bioavailability demonstrated an effect similar to aspirin (CX 268, p. 35,448).

392. In reaching its conclusion of efficacy of a wide variety of externally applied ingredients, the OTC External Analgesic Panel considered data from both controlled and uncontrolled subjective studies (CX 269, p. 69,778). The Panel also gave consideration to reports of long-term, widespread satisfactory clinical use and marketing experience in evaluation of ingredients. For example, the Panel based its determination that:

(a) the ingredient Stronger Ammonia Water was an effective external analgesic on the ingredient's wide use, its clinical acceptance, and on published reports in the literature (CX 269, p. 69,793);

(b) the ingredient Juniper Tar was an effective external analgesic based on the ingredient's wide use, clinical acceptance, **[121]** and on published reports in the literature (CX 269, p. 69,824);

(c) the ingredient Turpentine Oil was an effective external analgesic based on the ingredient's wide use, clinical acceptance, and on published reports in the literature. No scientifically controlled studies concerning the use of turpentine oil alone for the treatment of rheumatism, arthritis, or muscular aches and pains were submitted (CX 269, p. 69,840).

VIII. FDA DETERMINATIONS ABOUT TEA/S' ANALGESIC EFFICACY

393. The most authoritative record evidence that topical TEA/S' analgesic efficacy remains to be demonstrated is the consistent refusal of both the FDA and its External Analgesics Panel to find TEA/S to be effective for labeling purposes under the Food, Drug and Cosmetics Act. The first decision on TEA/S' lack of efficacy was that of the FDA's Advisory Review Panel in December of 1979 (CX 269). The Panel was unimpressed by the evidence of TEA/S' efficacy.

> The Panel does not give serious consideration to the claim that the drug penetrates the skin and passes directly into the affected deeper structures in sufficient concentrations to be effective because there is no data available to substantiate this claim (CX 269, p. 69,856).

394. In response to the Panel's rejection of TEA/S as a topical analgesic, both Thompson and Warren-Teed Pharmaceuticals, Inc., the maker of another topical TEA/S product, submitted additional material in 1980 to the FDA's Bureau of Drugs in an effort to reverse the Panel's decision (CXs 342–43). The material submitted by the companies included the Golden study (RX 49, discussed in F. 246–74, *supra*), the Golden and Altschuler study (RX 50, discussed in F. 275–98, *supra*), the Batterman and Sanders study (CX 254, discussed in F. 307–12, *supra*), the Patel and Chappelle materials (RX 35–37, discussed in F. 299–306, *supra*), the canine portion of the Rabinowitz study (RX 70, discussed in F. 315–20, *supra*), the Roth study (CX 344Z–195 discussed in F. 376–79, *supra*), the Ehrlich study (CX 344Z–157 discussed in F. 380–82, *supra*), the Charles study (CX 344Z–168 discussed in F. 383–85, *supra*), and [122] the Brown study (CX 344Z–182 discussed in F. 385, *supra*). As a result, the FDA's Bureau of Drugs had before it most of the clinical studies in evidence on this proceeding. The Bureau of Drugs reiterated the Advisory Panel's decision with respect to TEA/S, that there were not sufficient data to support the drug's efficacy as a topical analgesic (CXs 342C, 343D).

395. The current position of the FDA with respect to TEA/S' analgesic efficacy was formally announced upon publication of the tenative final monograph for external analgesics (CX 443) in which the FDA adopted the Panel's determination and affirmed the Bureau's position. The pertinent portion of the FDA's tentative final monograph (proposed rule) on external OTC analgesic drug products, announced February 8, 1983, is as follows:

> Two comments submitted data on the effectiveness of trolamine salicylate [TEA/S] as a topical analgesic. Based on these data, one of the comments suggested that the monograph include a class of external analgesics that "act upon painful structures below the skin by absorption of the active ingredient directly into subcutaneous structures" and that trolamine salicylate (TEA/S] be placed in this class. The comment also suggested the following indications for this class: "For the temporary relief of minor aches and pains of muscles and joints. Also as a topical adjunct for pain due to arthritis and rheumatism." Both comments suggested that trolamine salicylate [TEA/S] be placed in Category I based on the data submitted.
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> * * * * * * *
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> Because the submitted information fails to demonstrate that this ingredient would be effective for application at the site of pain or for any use as an external analgesic, the agency does not agree with the comments that trolamine salicylate [TEA/S] should be placed in a new class of external analgesic drug product. Trolamine salicylate [TEA/S] remains in Category III as an anesthetic, analgesic, and antipuritic in this tentative final monograph (CX 443, p. 5855). [123]

The FDA's proposed rule also specifically rejected as inadequate all of the material referred to in F. 394, *supra* (*Id.*).

396. Concomitantly, Dr. William E. Gilbertson, the Director of the Division of OTC Drug Evaluation, advised Thompson by letter dated February 9, 1983:

> All of the data and information in your Citizen petition and subsequent correspondence, as identified above, have been included in the Administrative Record. When the review of the data and information is completed, you will be notified of the Agency's findings pursuant to the Agency's feedback procedures (RX 296).

397. Included in the data submitted by Thompson to the FDA but not specifically considered by the FDA in its tentative final monograph (CX 443) are:

(i) Citizen Petition dated November 24, 1981 (RX 366), containing *inter alia,* the published report of Dr. Rabinowitz (RX 70 discussed in F. 315–29, *supra*); the pilot investigation of TEA/S's ability to influence prostaglandins synthesis (RPF 146 discussed in F. 355–63, *supra*); backup data from the Golden and Altschuler study (RX 50 discussed in F. 275–98, *supra*); written report and patient report forms on the French Clinical Trials conducted by Drs. Alain Patel and Pierre Andre Chappelle in 1976 and 1977 (RXs 35–37 discussed in F. 299–306, *supra*); as well as considerable marketing and consumer-generated information.

(ii) B.F. Ascher Company, Inc. survey of physicians (RX 346 discussed in F. 338–39, *supra*).

(iii) "Drug Delivery to Local Subcutaneous Structures Following Topical Administration" a review article by Drs. Guy and Maibach accepted [124] for publication in *The Journal of Pharmaceutical Sciences* (RX 1020).

(iv) Double-blind clinical study conducted at the Baltimore Center for Clinical Studies entitled "Double-Blind Clinical Evaluation of Aspercreme Plus Two Placebo Tablets Versus Aspirin Plus a Placebo Creme For Relief of Pain Associated with Arthritis," purporting to show that Aspercreme is as effective as aspirin.

See RB 17.

398. Of the pending FDA submissions by Thompson, referred to as "Your Citizen Petition and subsequent correspondence" in Dr. Gilbertson's letter of February 9, 1983 (RX 296). the only biomedical studies not specifically commented on and rejected as insufficient by the FDA to date are: the Rabinowitz study (RX 70 dicussed in F. 315–29, *supra*); the Guy and Maibach article (RX 1020 discussed in F. 324, *supra* and a clinical study conducted for Thompson by the Baltimore Center for Clinical Studies ("Baltimore study"). The last two evidently postdate Thompson's November 1981 FDA petition and thus could not have been possessed or relied on by Thompson as substantiation for the various advertising claims challenged in this proceeding.

399. In any event, the Rabinowitz study and the Guy-Maibach article are penetration studies and do not purport to show TEA/S' bioactivity. The Baltimore study compared Aspercreme plus placebo tablets and aspirin plus placebo creme, as did the Golden study (CX 200), and thus lacked placebo-control. The lack of placebo control is a basic methodological flaw in a pain study (*See* F. 228, *supra*). Furthermore, its failure to show significant difference between the two treatment groups ("Aspercreme was as effective as, if not better than, aspirin") does not demonstrate that Aspercreme and aspirin are equally effective (*See* F. 237, *supra*).

400. Therefore, it is highly unlikely that the FDA, as a result of its review and feedback procedures referred to in the Gilbertson letter (F. 396, *supra*), will reverse its position with respect to TEA/S' topical analgesic efficacy. Against this background, for the FTC to hold, on the basis of essentially the same evidence considered by the FDA, that Thompson's efficacy claims for Aspercreme are based on adequate medical/scientific substantiation for advertising purposes would not only be contrary to the prevailing view of the medical scientific community but also be tantamount to establishing a different and [125] lower standard of efficacy for OTC drug advertising than that applicable to OTC drug marketing.

401. In sum, the clinical trials on which Thompson relies are inadequate to demonstrate the effectiveness of TEA/S as an external

analgesic. The bioavailability studies are not a substitute for well-controlled clinical trials, but also on the whole they show that TEA/S is poorly absorbed and thus probably not bioactive. The physicians' observation and consumer testimonials upon which Thompson relies are corroborative evidence at best. And the general scientific literature and the various theories of TEA/S' mechanism of action are not a substitute for clinical demonstration of TEA/S efficacy.

402. From all the foregoing, it is found that at the time respondent made the advertising claims alleged in Paragraphs 12(a) and 14 of the complaint, it did not possess and rely on a reasonable basis for its claims that Aspercreme is an effective topical pain reliever, including arthritic pain.

IX. THOMPSON DID NOT HAVE A REASONABLE BASIS FOR COMPARATIVE EFFICACY CLAIMS

403. The record shows, and Thompson admits, that in order to show the comparative efficacy of two drugs, clinical trials directly comparing the two drugs are required (Adriani, Tr. 1177; Byers, Tr. 4384, CX 45Q (Admission No. 339); *see also, American Home Products Corp.*, 98 F.T.C. 136, 304–15 (1981), *modified*, 396 F.2d 681 (3rd Cir. 1982) [101 F.T.C. 698 (1983)]. The only clinical trial in evidence comparing the results of using oral aspirin and topical TEA/S is the Golden study (RX 48/CX 200) (Altschuler, Tr. 3060; CX 45I (Admission No. 142). The Golden study is not a well-controlled clinical study for the purpose of showing topical TEA/S' analgesic efficacy (*See* F. 246–74, *supra*). Accordingly, there is no reasonable basis for any claim about either TEA/S' parity with or superiority to oral aspirin. Moreover, since Thompson's substantiation materials as a whole fail to provide the required level of scientific proof of Aspercreme's basic analagesic efficacy, there is clearly no substantiation for claims regarding the comparative efficacy of TEA/S. Thus at the time of the representations alleged in Paragraphs 12(b), 12(c) and 14 of the complaint, Thompson did not have a reasonable basis for the claims that Aspercreme is either as effective as or more effective than oral aspirin for the relief of minor pain associated with arthritis and rheumatism, as alleged in Paragraphs 12(b), 12(c) and 14 of the complaint.

404. Accordingly, the claim that valid studies have scientifically proven that Aspercreme is more effective than **[126]** orally-ingested aspirin, as alleged in Paragraph 10(c) of the complaint, was, and is, false.

X. THOMPSON DID NOT HAVE A REASONABLE BASIS FOR EFFICACY CLAIMS ABOUT RHEUMATIC PAIN

405. Thompson has advertised Aspercreme as being effective for the relief of pain associated with rheumatic as well as arthritic conditions. With the exception of only one document (RX 63/CX 265), Thompson relies on the same materials to justify its claims for rheumatic conditions that it relied on for claims about arthritic conditions (CX 44A-B). For the reasons discussed in Section VII, these materials fail to demonstrate that topical TEA/S is an effective drug for pain relief. Since rheumatism is musculoskeletal pain by definition, the materials Thompson used for arthritic conditions do not constitute a reasonable basis for any claims about Aspercreme's efficacy for relief of rheumatic conditions and symptoms.

406. RX 63/CX 265 is a letter from an employee of Warren-Teed Pharmaceuticals which markets Myoflex (a 10% TEA/S rub), to Dr. Saul Heller, a psychiatrist who specializes in acupuncture and has been a consultant to Thompson for more than twenty years (Heller, Tr. 2566, 2604). Without disclosing his affiliation to Thompson, Dr. Heller wrote to Warren-Teed for information about its topical TEA/S product (Heller, Tr. 2629). Warren-Teed's reply (RX 63) briefly describes some bioavailability and clinical studies conducted by Warren-Teed on Myoflex. Dr. Heller never saw any of the studies mentioned in the letter, and the letter only suggests that Warren-Teed's product may be used as "an adjunctive therapeutic agent" (Heller, Tr. 2625–28; RX 63B). This letter adds nothing as a practical matter to the reasonable basis materials discussed in Section VII above. Accordingly, when Thompson made the representation alleged in Paragraphs 12(d) and 14 of the Commission's complaint there was no acceptable scientific support and no reasonable basis for the claim that Aspercreme is effective for the relief of rheumatic pain (Adriani, Tr. 1185; Roth, Tr. 1573–74).

XI. THOMPSON DID NOT HAVE A REASONABLE BASIS FOR CLAIMS ABOUT DRUG ACTION BY DIRECT PENETRATION

407. For the same reasons underlying the foregoing findings that there is no reasonable basis for Aspercreme's efficacy claims, it is found that there is no reasonable basis for the claim, alleged in Paragraphs 12(e) and 14 of the complaint, that Aspercreme provides pain relief by direct penetration to the site of arthritic pain. Moreover, the mechanism of pain or its **[127]** relief has not been definitively understood, and the bioavailability or penetration studies in evidence fall short of showing TEA/S' bioactivity or analgesic efficacy.

408. From all of the foregoing, it is found that:

(a) the advertising claims alleged in complaint paragraphs 10(a), 10(b) and 10(c) were false, misleading or deceptive;

(b) the advertising claims alleged in complaint paragraphs 12(a), 12(b), 12(c) and 12(d) lacked a reasonable basis and they were false as alleged in complaint paragraph 14; and

(c) the use of the brand name "Aspercreme" in advertising, labels and promotional materials is false, misleading or deceptive.

XII. RELIEF

409. With respect to certain Aspercreme advertising claims which were false or for which Thompson did not have a reasonable basis, the customary remedy is an order to cease and desist. It is necessary and appropriate in this case to require Thompson to refrain from making false and unsubstantiated claims in the future. Such false or unsubstantiated claims include:

(a) False claims:

(1) Aspercreme contains aspirin (Comp. ¶ 10(a)).

(2) Aspercreme is a newly discovered drug product (Comp. ¶ 10(b)).

(3) Valid studies have scientifically proven that Aspercreme is more effective than orally-ingested aspirin for the relief of minor pain [128] associated with arthritis and other rheumatic conditions (Comp. ¶ 10(c)).

(b) Unsubstantiated claims:

(1) Aspercreme is an effective drug for the relief of minor pain associated with arthritis or rheumatic conditions (Comp. ¶ 12(a) and (d)).

(2) Aspercreme is as effective as, or more effective than, orally-ingested aspirin for the relief of minor pain associated with arthritis (Comp. ¶ 12(b) and (c)).

(3) Aspercreme acts by directly penetrating through the skin to the site of arthritic pain (Comp. ¶ 12(e)).

410. With respect to an advertising claim for Aspercreme's efficacy, either in simple or comparative terms, the required reasonable basis comprises two or more adequate and well-controlled clinical trials which demonstrate Aspercreme's simple or comparative efficacy as an analgesic drug for the relief of minor pain associated with arthritis or other rheumatic conditions. This is what the prevailing view of the medical/scientific community requires, as does the FDA for OTC topical analgesic products for labeling purposes. Acceptance by the Federal Trade Commission of a lower level of scientific evidence of drug efficacy would not only be contrary to the prevailing and established view of the medical scientific community but also be tantamount to

establishing a different and lower standard of efficacy for OTC drug advertising under Section 5 of the FTC Act than that applicable to OTC drug marketing under the Food, Drug and Cosmetic Act.

411. The need for adequate substantiation is greater where, as here, a relatively obscure topical drug is being touted as proven effective pain reliever to the long-suffering arthritics, a group known to be singularly disposed to grasp at new promises of relief.

412. Thompson has been aware for some time that its advertising and the product's brand name may imply that [129] Aspercreme contains aspirin. For example, the networks and the NAB Code Authority challenged Aspercreme commercials with respect to the aspirin content suggestion, as well as challenging Thompson's substantiation for its efficacy claims (*See, e.g.*, CX 88D, 92). Thompson also was aware of the results of the Mapes & Ross copy test (which showed that an aspirin content message was being communicated) at least as early as June 14, 1979, at which time the test was discussed in a meeting between Ogilvy & Mather and Thompson (*See*, CX 99A: F. 95, *supra*). In a document setting out the strategy for Aspercreme advertising, Thompson's advertising agency stressed the importance of the aspirin communication (CX 54Z ("the 'aspirin' component of Aspercreme is uniquely relevant for arthritis"), Z–002 (discussion of "aspirin in a rub" as the ad strategy), Z–005 (creative strategy: "Aspercreme contains the pain relieving ingredient of aspirin"), Z–007 ("it is the *local aspirin relief* that is important"), Z–012 (with respect to an Aspercreme print ad: "the client has grown to believe it doesn't communicate arthritis or aspirin very well, and we are in the process of developing a new one")). Since representatives of the ad agency communicated regularly with Thompson in the creation of ad strategy and had to get direct approval from Thompson for the strategy (Jasper, Tr. 4815–16), it is reasonable to infer that the ad agency's expressions in CX 54 were known to Thompson. CX 66 is a conference report summarizing a meeting between Thompson and Ogilvy & Mather, at which Thompson gave approval for certain Aspercreme ads to be run (Jasper, Tr. 4794–97). Among those ads were CX 3 and CX 4, television commercials including the network-mandated "contains no aspirin" disclosures. The report states, "the client [Thompson] agreed and will pursue approval of the *aspirin equivalency* claim. In the meantime, the agency will pursue using the 'strong relief of aspirin' claim *to offset the contains no aspirin super*"(CX 66B, emphasis added). CX 66 was sent to Thompson's president, as well as to other Thompson representatives (CX 66A).

413. The record also clearly shows that a significant segment of consumers are likely to get the impression that Aspercreme contains aspirin, either from the brand name "Aspercreme" alone or from

other language in the ads or both, and that ingredient disclosure statements (such as "Aspercreme contains salicyn, a strong non-aspirin pain reliever") or aspirin disclaimers in the ads (such as "does not contain aspirin" super) are ineffective in preventing the consumer perception that Aspercreme is an aspirin product (Cohen, Tr. 287–88, 549–50, 558–60). Therefore, stronger measures are required in Aspercreme advertising in the future in order to insure that the viewer of such advertisements are not misled thereby (*See* F. 84, 101, 116). **[130]**

414. It is the determination of the administrative law judge that, based on the record as a whole an effective aspirin disclaimer should be explicit and unequivocal and should include both audio and video messages which are prominent enough and conspicuous enough to assure that the intended objective will be achieved. In television commercials, a prominent and conspicuous video aspirin disclaimer (such as "Aspirin Free" super) should be displayed throughout the commercial as well as a vocal aspirin disclaimer statement (such as "Aspercreme does not contain aspirin") made at the end of each commercial. In print or radio advertising, the printed or vocal aspirin disclaimers should be explicit and unequivocal and be prominent and conspicuous in relation to each advertisement as a whole. It is the opinion of the adminstrative law judge that without an effective disclaimer measure as described above, a continued use of the brand name "Aspercreme" in advertising will be clearly misleading and deceptive.

415. The brand name Aspercreme was registered in the United States Patent Office under Registration No. 933,107 issued in 1972 (RX 921). It also has been registered in many foreign countries (RX 601A). Furthermore, the perception that Aspercreme contains aspirin is not a result of the natural and literal meaning of the trade name itself but a result of the confusion created by its proximity to "aspirin." The trade name excision complaint counsel advocate is not justified under the circumstances of this case. On the basis of this record, I am unable to conclude that the brand name excision is the only adequate remedy or that a less restrictive remedy (such as effective disclaimers) cannot be devised that will prevent the impression on the part of the viewer that Aspercreme ads represent that the product contains aspirin. *See Beneficial Corp. v. FTC*, 542 F.2d 611, 619 (3rd Cir. 1976).

416. It is found that the cease and desist order provisions should be limited to OTC analgesic products. The record evidence does not justify an "all drug products" provision sought by complaint counsel. [131]

DISCUSSION

The record shows that the capacity of the challenged Aspercreme advertisements to mislead a significant segment of reasonable consumers is palpably real, that the deception is material and substantial in health, economic and societal terms, that the information regarding the availability of a topical OTC drug alternative to oral medication can easily and effectively be communicated in advertisements without implying false, deceptive or misleading claims, and that the benefits of requiring adequate substantiation of Aspercreme efficacy claims clearly outweigh potential costs of such requirement. The record also shows that the brand name "Aspercreme" is misleading and that the kind of fleeting aspirin disclaimers (such as "Does not contain aspirin" super displayed for a few seconds) or equivocal ingredient statements (such as "contains salicyn, a strong non-aspirin pain reliever") in Aspercreme ads are not sufficient and more effective, straight-forward aspirin disclaimers are needed. The basic findings with respect to the various disputed issues of law and fact and the reasons for the conclusions reached are set forth in the preceding sections. However, a brief discussion of some key issues may be in order.

1. *The Meaning Of Aspercreme Advertisements And The Materiality Of Aspirin Content*

Thompson argues that its Aspercreme ads sought merely to inform arthritis sufferers that there is an alternative topical OTC remedy which provides as much pain relief as do aspirin tablets without stomach upsets often caused by aspirin tablets. A careful examination of the individual advertisements in evidence, however, has convinced me that, whatever Thompson's intent, these ads *also* made, sometimes directly but mostly by implication, the various representations alleged in the complaint, except for paragraph 12(f). Empirical data, including the four copy tests conducted in connection with this litigation (CXs 26 and 27; RXs 500 and 520), generally confirm what common sense and experience would tell us, namely that the Aspercreme ads, including the use of the brand name "Aspercreme," can reasonably be expected to mislead a significant number of consumers in the manner alleged in the complaint.

The record also amply demonstrates that the presence or absence of aspirin in an OTC analgesic product clearly is a material fact within the meaning of Section 12 of the FTC Act (*See* F. 162–63, *supra*). [132]

2. *The Requirement For Well-Controlled Clinical Studies As A Reasonable Basis For Aspercreme Efficacy Claims*

The thrust of Thompson's argument regarding the reasonable basis issue is essentially that, on the basis of the totality of evidence of TEA/S, including clinical trials, drug penetration studies, physician's opinions and clinical experience, marketing experience, user testimonials and consumer reactions regarding Aspercreme over the years, it was reasonable for Thompson to make those advertising claims challenged in this proceeding (RB 59–72). Thompson argues that Aspercreme is a mild and harmless topical product which demonstrably provides tangible benefits to a significant segment of the target population and that, therefore, it should be permitted to make efficacy claims in advertising without the kind and level of medical scientific substantiation required for more potent, potentially harmful drugs (RB 61–62). However, the Commission has determined that with respect to the issue of *efficacy* of an OTC analgesic drug, two or more well-controlled clinical trials are required to prove simple or comparative efficacy. *American Home Products Corp.*, 98 F.T.C. at 376. Therefore, an argument that a level of substantiation less than two well-controlled clinicals constitutes a reasonable basis for the simple and comparative *efficacy* claims made for Aspercreme, a topical OTC analgesic drug, is not acceptable.[3]

Thompson also argues that the FDA does not require two well-controlled studies in the case of the so-called "old" OTC drugs [133] (RPF 64–66). Thompson further argues that, in any event, the FDA relies on uncontrolled clinical trials, clinical observations of physicians and marketing experience related to the product in determining the issue of efficacy of OTC drugs (*See* RPF 123–25).[4] Thompson also urges that "under the principles of *res judicata* and collateral estoppel" the FTC should apply to drug efficacy issues in FTC proceedings the same standard the FDA employs in determining drug efficacy. Indeed Thompson points out that "the Commission has itself used the finding of the FDA to reach its own finding that advertising was deceptive," citing *Simeon Mgt. Corp. v. FTC*, 579 F.2d 1137, 1145 n. 10 (9th Cir. 1978) (*See* RB 99–100). According to this argument, the FTC should accept, as the FDA allegedly would, evidence less than two or more well-controlled clinicals as proof of analgesic efficacy of Aspercreme. In my view, these arguments are unpersuasive. As the Commission has explicitly recognized in *American Home Products*, the FDA requires under the Food, Drug and Cosmetic Act two or more well-controlled clinical studies as proof of efficacy with respect to all drugs, including OTC analgesic drug products. 98 F.T.C. at 378–81.

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[3] In this connection, the record shows that TEA/S is not an effective systemic or internal analgesic (*See* CX 268) but is an effective topical sunscreen agent (F. 362, *supra;* CX 270, pp. 38,251–53). An important property of 5–12% TEA/S as a sunscreen product is its ability to remain on the skin long enough to form an effective surface barrier against ultraviolet rays of the sun. Yet, Thompson's hypothesis regarding Aspercreme's (10% TEA/S) analgesic action is that it penetrates the skin and delivers a therapeutic level of salicylate to the site of pain in the underlying deep tissues of the musculoskeletal system in humans. The records also shows that the use of an unproven OTC drug for self-medication to treat rheumatic pain poses a real danger to the consumer and may result in significant losses of individual and societal resources (F. 207–10, *supra*). In these circumstances, common sense dictates that Aspercreme's analgesic efficacy be subjected to as rigorous a test as, if not more rigorous than, that required of OTC internal analgesic products. *Also see,* F. 242, *supra.*

[4] These arguments ignore Thompson's own statement that "the FDA [OTC monograph] procedures now provides a period until April 9, 1984 for the development and review of evidence that will permit final classification of the effectiveness of TEA/S" and that "during this period the marketing of TEA/S products is, of course, permitted" (RB 18). The "evidence that will permit final classification of the effectiveness of TEA/S" in this context, of course, includes two or more adequate and well-controlled clinical trials.

The most authoritative record evidence that topical TEA/S' analgesic efficacy remains to be demonstrated is the consistent refusal of both the FDA and its OTC External Analgesic Panel to find topical TEA/S to be effective under the Food, Drug and Cosmetic Act (*See* F. 393–95, *supra*). Having reviewed substantially all of the material and information presented in this proceeding, the FDA has announced, in the February 8, 1983 Tentative Final Monograph [proposed rule] on OTC External Analgesic Drug Products, its determination that there was insufficient evidence to conclude that TEA/S is an effective topical analgesic agent. Against this background, the need for regulatory harmony and uniform standards among federal agencies with respect to the issue of drug efficacy dictates that the FTC require in this proceeding the same level of medical scientific [134] evidence the FDA requires under the Food, Drug and Cosmetic Act.[5] Thompson has urged as much (RB 99–100).

In light of the foregoing discussion, Thompson's argument that the requirement for well-controlled clinicals in this case is somehow "excessive" and that it is likely to result in limiting the amount of "useful information" made available to consumers is inapposite (*See* RB 59–61). The record clearly shows the substantial harm that misinformation regarding OTC [135] analgesic drugs may cause to the long suffering arthritics as well as to the society as a whole (F. 207–10, *supra*). The record also shows that the message Thompson claims to have sought to convey to the consumer, namely that Aspercreme is an effective topical alternative to oral aspirin, can easily and clearly be conveyed without implying unproven claims of comparative efficacy. In these circumstances, a ban against unproven claims of simple and comparative efficacy for Aspercreme is imperative. Thus, the determination that a reasonable basis for Aspercreme efficacy claims should include well-controlled clinical studies reflects a careful weighing of the possible benefits to consumers if Thompson's efficacy claims are true and the possible costs to consumers if the claims are false. *See* The FTC Statement of Policy on the Scope of the Consumer Unfairness Jurisdiction, 43 Trade Reg. Rep., 570 (1982).

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[5] Under the FDA's monograph procedures for OTC external analgesic drug products, the marketing of TEA/S products, including Aspercreme, will be permitted for an interim period until April 9, 1984, pending development and review of "evidence that will permit final classification of the effectiveness of TEA/S," presumably including two or more well-controlled clinical trials (F. 9, *supra*).

In this connection, Thompson obliquely suggests that the FDA might change its position regarding TEA/S when the FDA completes a review of Thompson's "pending" submissions (RB 16–18). However, on the basis of the record, the outcome Thompson suggests is highly unlikely (*See* F. 396–400, *supra*). In any event, the Order makes provision for the contingency that the FDA might, on the basis of new evidence, determine TEA/S to be an effective external analgesic agent. Should that contingency occur, the Order would allow respondent to rely on the same evidence the FDA relied on in the monograph proceeding. That provision will also cover other OTC analgesic drug products that may be marketed by respondent in the future. In this connection, it should be noted that the FDA, in the OTC monograph proceeding, determines the conditions under which OTC analgesic drug products are "generally recognized as safe and effective and not misbranded" and does not deal with the issue of *comparative* efficacy as such (*See* CX 443, pp. 5852–53).

In sum, should the FTC Order herein become effective before April 9, 1984, it would have the practical effect of barring Thompson from advertising Aspercreme as a topical analgesic while Thompson is being permitted by the FDA to continue marketing Aspercreme during the interim period. It may well be that the time required for the final determination of this proceeding may moot the issue. However, in the interest of comity and regulatory harmony, the Order should provide for a grace period similar to the FDA's (namely a period until April 9, 1984) during which simple, non-comparative efficacy claims for Aspercreme may be allowed in advertising. It is the law judge's view, however, that all ad claims of *comparative* or superior efficacy for Aspercreme should cease forthwith and not be allowed until such claims can be adequately substantiated.

In any event, as the Commission has recognized, the Supreme Court has indicated that the First Amendment does not shield deceptive advertising against appropriate prior restraints needed to prevent its recurrence. *See American Home Products Corp.*, 98 F.T.C. at 403–04, and the cases cited therein.

In this connection, a proposed restriction on commercial speech (including the brand name) designed to prevent recurrence of deception should be viewed in the information cost perspective so as not to inhibit dissemination of economically efficient information.[6] However, it should also be borne in mind that information in this context means accurate, truthful information.[7] False, misleading or deceptive advertising or brand name is not economically efficient. On the contrary, it increases the costs of information about the qualities of products and is economically inefficient. This is such a case.

3. *The Advertising Claims That Aspercreme Is A Newly Developed Drug And That It Has No Side Effects*

It is true that certain early Aspercreme advertisements contain an express or implied claim that Aspercreme is a new drug, as alleged in paragraph 10(b) of the complaint. However, [136] the history of Aspercreme advertising supports the view that Thompson was attempting to bring Aspercreme to the consumer's attention during the period when Aspercreme was being nationally advertised for the first time. In my view, Section 5 gives an advertiser some leeway in making a "new drug" claim during the introductory phase even though the same or similar products may have been available on the market. In any event, Thompson should not make "new drug" claims for Aspercreme in the future.

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[6] *See* Coase, R.H., *The Problem of Social Cost*, 3 J. of Law & Econ., 1, 15 (1960); Alchian, A. & Allen, W.R., EXCHANGE AND PRODUCTION: COMPETITION, COORDINATION AND CONTROL, 110–11, 124, 294–95 (2d ed. 1977).

[7] Alchian & Allen, *supra*, at 124.

It is also true that some of Thompson's advertisements contain an express "no side effects" claim, as alleged in paragraph 12(f) (CXs 7, 8, 10, 11). The record also shows that Aspercreme in fact can irritate the skin in some users (Golden, Tr. 2700–01; RX 35Z002). However, when each advertisement (CXs 7, 8, 10, 11) is viewed separately, I am unable to conclude that any of these advertisements can be reasonably understood by viewers as saying that Aspercreme has literally no side effects. It is common knowledge that any topical drug may irritate the skin in some persons. In may view, these ads were saying either that Aspercreme does not cause stomach discomforts as aspirin tablets often do or that Aspercreme has no serious side effects to worry about. To impute any more to the "no side effects" claim in these ads would be unreasonable. Therefore, complaint allegations in paragraph 12(f) will be dismissed.

4. *The Trade Name Excision Issue*

Complaint counsel vigorously argue that the record evidence demonstrating the misleading effect of the brand name "Aspercreme" clearly justifies its excision (CB 109–16). They urge essentially that the brand name "Aspercreme" is so close to "aspirin cream" that any qualification of the name will necessarily involve a contradiction in terms, adding to confusion rather than removing it. Complaint counsel further assert that, when the names of drugs or other medical products are at issue, courts readily have found confusion from less proof of confusing similarity because of the risk of physical harm to the consumer (CB 111). However, trade name excision is an extreme and harsh remedy and should not be employed except in cases where there is no meaningful alternative.

Although the evidence does not show that the brand name "Aspercreme" has acquired a secondary meaning associating it with some standard or price, "Aspercreme" has been in use as a registered brand name since 1972 and extensively advertised on a national scale as an OTC topical analgesic since 1979. As such, "Aspercreme" is a valuable business asset to respondent. *Cf., Friedman v. Rogers,* 440 U.S. 1, n. 11 at 12 (1978). Furthermore, in my view, there is a reasonable, common sense distinction to be made between "aspirin cream" or "Jay's [137] aspirincreme" on the one hand and "Aspercreme" on the other. In the former, the natural and literal meaning of the names would be "a creme made of aspirin." These names do not involve any ambiguity. In the latter, the construction that the product contains aspirin is due to the name's ambiguity, or proximity to "aspirin," and the confusion is not attributable to the natural and literal meaning of the name itself. In these circumstances, applicable precedents require that the Commission fully examine less restrictive measures including the feasibility of requiring rewriting of advertising copy in lieu of total excision. *Beneficial Corp. v. FTC*, 542 F.2d 611, 619 (3rd Cir. 1976); *Continental Wax Corp. v. FTC*, 330 F.2d 475, 479–80 (2d Cir. 1964).

The evidence shows that the direct or indirect aspirin disclaimers used heretofore in Aspercreme ads are ineffective and that, therefore, stronger, more conspicuous aspirin disclaimers are required (F. 84, 101, 116, 413–14, *supra*). Thus, simple, unequivocal aspirin disclaimer statements must be prominently and conspicuously made both in audio and video form in all Aspercreme ads in order to insure that the ambiguity and confusion resulting from the brand name "Aspercreme" are effectively removed. Therefore, the order will include appropriate provisions which will require, in television advertisements, "Aspirin- free" video super throughout the entire commercial *in addition to* a vocal disclaimer "Aspercreme does not contain aspirin" at the end of each Aspercreme commercial. In radio ads, one clear aspirin disclaimer statement at the end of the commercial will be sufficient. In print ads, a simple and unequivocal aspirin disclaimer statement, such as "ASPERCREME DOES NOT CONTAIN ASPIRIN," should be prominently and conspicuously placed in relation to each advertising copy as a whole (F. 415, *supra*).

CONCLUSIONS OF LAW

1. The Federal Trade Commission has jurisdiction over the advertising of Aspercreme under Section 5 of the Federal Trade Commission Act.

2. Respondent's use of false, misleading and deceptive advertising representations (including the brand name "Aspercreme") as herein found has had and now has the capacity and tendency to mislead members of the purchasing public into the erroneous and mistaken belief that said statements and representations were and are true and into the purchase of substantial quantities of Aspercreme by reason of said erroneous and mistaken belief. In the absence of an appropriate order, such members of the purchasing public are likely to continue to purchase substantial quantities of Aspercreme in the mistaken [138] belief that respondent's past advertising representations regarding the aspirin content of Aspercreme, Aspercreme's novelty, and the efficacy and comparative efficacy of Aspercreme (including the existence of valid studies proving Aspercreme to be more effective than aspirin), were true or were supported by a reasonable basis.

3. The acts and practices of respondent as herein found were and are all to the prejudice and injury of the public and of respondent's

competitors and constituted and now constitute unfair methods of competition and unfair and deceptive acts and practices in commerce in violation of Sections 5 and 12 of the Federal Trade Commission Act.

4. The accompanying order is necessary and appropriate for the purpose of prohibiting the continuation of the proscribed acts.

ORDER

I

It is ordered, That respondent, Thompson Medical Company, Inc., a corporation, its successors and assigns, and respondent's officers, representatives, agents and employees, directly or through any corporation, subsidiary, division or other device, in connection with the labeling, advertising, offering for sale, sale or distribution of any over-the-counter analgesic "drug" as that term is defined in the Federal Trade Commission Act, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

A. Employing the brand name "Aspercreme" for such products or otherwise representing directly or by implication that an active ingredient of such product is aspirin, unless such product contains aspirin in therapeutically significant quantities or unless the advertising and labeling for such product clearly and prominently discloses that the product does not contain aspirin.

(1) In television advertisements, an explicit and simple aspirin disclaimer statement (such as **[139]** "ASPIRIN-FREE") shall be superimposed and prominently displayed throughout the length of each advertisement as well as a vocal aspirin disclaimer statement (such as "Aspercreme does not contain aspirin") at the end of each advertisement.

(2) In radio advertisements, an explicit aspirin disclaimer statement (such as "Aspercreme does not contain aspirin") shall be made at the end of each advertisement.

(3) In print advertisements, an explicit aspirin disclaimer statement (such as "ASPERCREME DOES NOT CONTAIN ASPIRIN") shall be displayed prominently and conspicuously in relation to each such advertisement as a whole.

(4) In labeling, an explicit aspirin disclaimer statement (such as "DOES NOT CONTAIN ASPIRIN") shall be prominently and conspicuously printed in the front package panel (or in the front of the container if no package is used).

B. Representing, directly or by implication, that such product is new, or involves a new mechanical or scientific principle except during the product's introductory period, when such product or one involving such principle has been generally available for purchase in the United States for more than one year.

C. Misrepresenting the contents, validity, results, conclusions, or interpretations of any test or study.

II

It is further ordered, That Thompson Medical Company, Inc., a corporation, its successors and assigns, and respondent's officers, representatives, agents and employees, directly or [140] through any corporation, subsidiary, division or other device, in connection with the labeling, advertising, offering for sale, sale or distribution of any OTC analgesic "drug," as that term is defined in the Federal Trade Commssion Act, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desit from:

A. Representing, after April 9, 1984, that such product is effective for the relief of minor pain and other symptoms of any musculoskeletal disorder (such as arthritis, tendinitis, bursitis, or rheumatic disorders);

B. Representing that such product is as fast as or faster than, or is as effective as, or more effective than any other drug or device in the relief of minor pain and other symptoms of any musculoskeletal disorder (such as arthritis, tendinitis, bursitis, or rheumatic disorders);

unless at the time of the dissemination of any such representation, respondent possesses and relies upon a reasonable basis for such representation consisting of competent and reliable scientific or medical evidence. For analgesic drug products competent and reliable scientific or medical evidence shall include at least two adequate and well-controlled, double-blinded clinical studies which conform to acceptable designs and protocols and are conducted by different persons, independently of each other. Such persons shall be qualified by training and experience to conduct such studies. *Provided however,* with respect to any representation covered by this part other than claims of superior or comparative effectiveness or safety, if the Food and Drug Administration promulgates any final standard which establishes conditions under which such product is safe and effective under the Food, Drug and Cosmetic Act, then in lieu of the above, respondent may rely upon scientific evidence which fully conforms to such final standards as a reasonable basis for said representation.

III

It is further ordered, That so much of the complaint as relates to Paragraph 12(f) be, and the same hereby is, dismissed.

OPINION OF THE COMMISSION

By Douglas, *Commissioner:*

I. INTRODUCTION

Thompson Medical Company, Inc. ("Thompson") is a pharmaceutical company that sells several different over-the-counter ("OTC") drugs. One such drug is Aspercreme, a topical cream rub or lotion whose active ingredient is 10% triethanolamine salicylate ("TEA/S"). Thompson has marketed Aspercreme as a remedy for relief of minor arthritis pain since 1976, after purchasing it from the Sperti Drug Company. At first, Thompson followed Sperti's practice of marketing the product locally in Ohio. Starting in 1978, however, Thompson began a successful national advertising campaign for Aspercreme which saw sales of the product increase from $589,000 in 1978 to $5.9 million in 1981 (IDF 74.)[1] [2]

On February 5, 1981, the Commission issued a complaint against Thompson and its advertising agency, Ogilvy and Mather, Inc. The complaint charges that Thompson's marketing campaign for Aspercreme involved the following deceptive representations:

Complaint Paragraph Number	Alleged Representation
10(a), 16	Aspercreme contains aspirin.[2]
10(b)	Aspercreme is a recently discovered or developed drug product.

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[1] The following abbreviations are used in this opinion:

ID	–	initial decision page number
IDF	–	initial decision finding number
Tr.	–	transcript of testimony page number
CX	–	complaint counsel's exhibit number
CPF	–	complaint counsel's proposed findings of fact and conclusions of law finding number
CMF	–	complaint counsel's memorandum supporting proposed findings of fact and conclusions of law page number
CAP	–	complaint counsel's appeal brief page number
CAB	–	complaint counsel's answering brief page number
RX	–	respondent's exhibit number
RPF	–	respondent's proposed finding of fact and conclusions of law finding number
RMF	–	respondent's memorandum supporting proposed findings of fact and conclusions of law page number
RAP	–	respondent's appeal brief page number
RRB	–	respondent's reply brief page number

[2] Complaint Paragraph 10(a) charges Thompson generally with representing that Aspercreme contains aspirin. Complaint Paragraph 16 specifically charges that use of the trademark "Aspercreme" constitutes such a representation.

10(c) Valid studies have scientifically proven that Aspercreme is more effective than orally-ingested aspirin for the relief of arthritis, rheumatic conditions, and their symptoms.
12(a) Aspercreme is an effective drug for the relief of minor arthritis and its symptoms.
12(b) Aspercreme is as effective a drug as orally-ingested aspirin for the relief of minor arthritis and its symptoms.
12(c) Aspercreme is a more effective drug than orally-ingested aspirin for the relief of minor arthritis and its symptoms. [3]
12(d) Aspercreme is an effective drug for the relief of rheumatic conditions and their symptoms.
12(e) Aspercreme acts by directly penetrating through the skin to the site of the arthritic disorder.
12(f) The use of Aspercreme will result in no side effects.
14 Thompson had a reasonable basis for representations listed in Complaint Paragraphs 12(a)-(f) at the time they were made.

The complaint alleges that representations listed in Complaint Paragraphs 10, 14, and 16 are false, misleading, and deceptive. It further alleges that Thompson lacked a reasonable basis for the representations listed in Complaint Paragraph 12.

The case was assigned to Administrative Law Judge Montgomery K. Hyun for hearing. On July 7, 1983, Judge Hyun entered his initial decision, which found against Thompson on all charges except those relating to claims that Aspercreme had no side effects (Comp. ¶12(f)).[3] The order he adopted requires Thompson to have a reasonable basis for claims that any OTC analgesic drug is effective for the relief of symptoms of musculoskeletal disorder, and for comparative efficacy claims made for such a [4] drug. The order further prohibits Thompson from: (1) using the brand name "Aspercreme" unless it is accompanied by a disclosure that the product does not contain aspirin; (2) representing that a product is new if it has been generally available for purchase in the United States for more than one year; and (3) misrepresenting any test or study.

Thompson appeals from the ALJ's findings as to liability. Thompson's principal arguments on appeal are: (1) the ALJ erred in finding that Thompson lacked reliable and credible information constituting a reasonable basis for the efficacy claims it made for Aspercreme; (2) the ALJ erred in finding Aspercreme not to be an effective drug for the relief of minor arthritis or rheumatism pains; and (3) the ALJ erred in finding that either the trademark "Aspercreme" or the product 's advertising deceptively represent that the product contains aspirin. Complaint counsel appeal from the ALJ's decision not to prohibit Thompson from using the "Aspercreme" brand name. Complaint counsel also appeal the ALJ's decision to limit Part I of the order to OTC analgesic drugs, rather than all OTC drugs, and not to have Part I prohibit false ingredient representations involving any brand name and any active ingredient.

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[3] Prior to Judge Hyun's decision, the Commission adopted a Decision and Order settling the charges against Ogilvy & Mather. *In the Matter of Oglivy & Mather International, Inc.*, Docket No. 9149, Decision and Order issued January 4, 1983. [101 F.T.C. 1 (1983)]

We generally agree with the ALJ's findings and conclusion and, except as noted in this opinion, adopt them as our own. Our analysis of the issues presented here is in four parts. First, we determine whether or not Thompson made the representations alleged in the complaint. Second, we evaluate whether or not the representations were material. Third, we examine whether or not [5] the claims were likely to mislead consumers acting reasonably under the circumstances.[4] Finally, in light of our determinations as to the extent and severity of Thompson's deceptive advertising, we consider the appropriate scope of an order prohibiting such conduct in the future.

II. DID THOMPSON MAKE THE REPRESENTATIONS ALLEGED IN THE COMPLAINT?

1. *Legal Framework*

In this part of the opinion, we examine whether Thompson's advertising expressly or impliedly conveyed to consumers the representations listed in the complaint. As our discussion below will show, we conclude that it generally did. Before analyzing the advertising itself, however, we will set out the standards by which we do so. [6]

As we noted in *Cliffdale Associates*,[5] we will deem an advertisement to convey a claim if consumers acting reasonably under the circumstances would interpret the advertisement to contain that message. The purpose of such a requirement is to ensure that the flow of useful, accurate information to consumers will not be deterred by advertisers' fears that they could be held responsible for claims that they could not reasonably have known consumers were going to receive from the ads in question.

In evaluating what message an ad could reasonably be interpreted as containing, the Commission has traditionally distinguished between express and implied claims. Express claims are ones that directly state the representation at issue. Because the message is stated unequivocally, it is reasonable to interpret the ads as intending to make the claim.[6] Implied claims are any claims that are not express.

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[4] As Commissioner Bailey noted in her Concurring and Dissenting Statement in *Cliffdale Associates, Inc.*, Docket No. 9156 (March 23, 1984), she believes the elements of deception are that an act or practice have the tendency or capacity to mislead a substantial number of consumers in a material way. She did not endorse the Commission's *Cliffdale* description (slip op. at 7) of the elements of deception nor does she endorse it in this opinion. However, Commissioner, Bailey agrees that respondent's practices in this case were deceptive under either description of the term. [103 F.T.C. 110 (1984)]

[5] *Id.*

[6] This is the only issue we look at. We do not additionally consider whether the advertiser intended to deceive consumers with the claim or whether an objective product claim (*i.e.*, one not involving puffery or subjective value

(footnote cont'd)

They range from claims that would be virtually synonymous with an express claim [7] through language that literally says one thing but strongly suggests another to language which relatively few consumers would interpret as making a particular representation.[7]

Because of this wide range, the Commission employs two different techniques in evaluating whether an advertisement contains implied claims. One is to look at evidence from the advertisement itself. We often conclude that an advertisement contains an implied claim by evaluating the contents of the advertisement and the circumstances surrounding it. This technique is primarily useful in evaluating advertisements whose language or depictions are clear enough, though not express, for us to conclude with confidence after examining the interaction of all the different elements in them that they contain a particular implied claim.

If our initial review of evidence from the advertisement itself does not allow us to conclude with confidence that it is reasonable to read an advertisement as containing a particular implied message, we will not find the ad to make the implied claim unless extrinsic evidence allows us to conclude that such a [8] reading of the ad is reasonable.[8] For example, in this case the conflicting messages in some elements of Aspercreme's ads caused us to examine extrinsic evidence to determine what net impression(s) the entire ad could reasonably be interpreted as giving to consumers.[9]

The extrinsic evidence we prefer to use and to which we give great weight is direct evidence of what consumers actually thought upon reading the advertisement in question. Such evidence will be in the form of consumer survey research for widely distributed ads, such as those involved in this proceeding. Ads of that sort are directed at so large an audience that it is too costly to obtain the statements of enough individual consumers in another manner (*e.g.*, by way of af-

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judgments) is so far-fetched that reasonable consumers would not believe it. Thus, if an ad expressly claims that a shampoo will cure baldness, we presume that reasonable consumers would be deceived by the ad. We presume this even though we might think few people are unaware of the fact that there is no cure for common baldness. *See, e.g., Keele Hair & Scalp Specialists, Inc.* 55 F.T.C. 1840 (1959), *aff'd*, 275 F.2d 18 (5th Cir. 1960).

[7] Advertisements do not necessarily convey one message to all persons. One subset of consumers reading an ad may interpret it to contain one message, while another subset may interpret it to contain a different message. Each interpretation is reasonable as long as the subset making it is representative of the group of persons to whom the ad is addressed. *See, e.g., Heinz W. Kirchner*, 62 F.T.C. 1282, 1290 (1963).

[8] This longstanding principle of Commission case law was most recently reiterated by us in *Bristol-Myers Co.*, 102 F.T.C. 21, 319 (1983), *aff'd*, 738 F.2d 554 (2d Cir. 1984) *petition for cert. filed* (No. 84-650) (Oct. 23, 1984), a case involving deceptive advertisements for OTC internal analgesic products: "There also may be instances where claims cannot be inferred from a facial examination of the advertisements and resort to extrinsic evidence is necessary. *See, e.g., Leonard F. Porter, Inc.*, 88 F.T.C. 546, 626 (1976)."

[9] Similarly, past Commission cases recognize that affirmative disclosures can be an effective method for preventing consumer misunderstanding of ads. However, Commission cases also recognize that such disclosures need to be made clearly and prominently to be effective. Whether or not a particular disclosure was clear and prominent is a question for whose answer we often would seek information in addition to that from the ad itself. However, where a simple inspection of the ad leaves us confident that the disclosure was ineffective for ordinary consumers, we will not require extrinsic information. *See, e.g., Litton Industries, Inc.*, 97 F.T.C. 1, 71, n.6 (1981), *aff'd as modified*, 676 F.2d 364 (9th Cir. 1982).

fidavits) to be reasonably confident that the consumers' views on the record of the proceeding were representative of the entire [9] group to which the ad was addressed. Where we use surveys in lieu of individual testimony, the surveys are methodologically sound; they draw valid samples from the appropriate population, ask appropriate questions in ways that minimize bias, and analyze results correctly.[10]

Another type of evidence we will look at is evidence not specifically showing how consumers understood the advertisements at issue before us, but showing how consumers might ordinarily be expected to perceive or understand representations like those contained in the ads we are reviewing. For example, we might look at the dictionary definition of a word to identify the word's common usages. Or we might look at principles derived from market research, as expressed by marketing experts, which show that consumers generally respond in a certain manner to ads that are presented in a particular way, and presume that consumer reactions to a particular ad before us would be consistent with the general response pattern. Where we apply such marketing principles, we will derive them from research presented in references generally accepted as reliable in the field of marketing. Such references may be cited by marketing experts called to testify in the proceeding. Alternatively, we may take official notice of the references and cite to them directly in our opinion. [10]

A third type of evidence we will consider if offered is the opinion of expert witnesses in the proceeding as to how an advertisement might reasonably be interpreted. For example, we might consider the opinion of a marketing expert who stated his or her view that consumers would interpret an ad in a particular manner. However, where the opinions voiced by experts are not adequately supported we ordinarily give them little weight.[11]

Whether we are looking at evidence from the ad itself, extrinsic evidence, or both, we look at the overall, net impression made by an ad to determine what messages it reasonably can be interpreted as conveying to consumers.[12] For example, we would look here at whether or not consumers thought, after viewing Thompson's television ads, that Aspercreme contains aspirin. We would not look at how consumers reacted to a particular element from the ad in a different context than the ad itself.

In this case, Thompson has acknowledged making several of the represenations listed in the complaint (RMF 142–43). These are: [11]

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[10] *See, e.g.*, our discussion of survey methodology in *Bristol-Myers Co.*, 85 F.T.C. 688, 744 n.14 (1975).

[11] We consider to be adequately supported opinions that describe empirical research or analyses based on generally recognized marketing principles or other objective manifestations of professional expertise. Opinions not so supported may easily be contradicted by the contrary opinions of opposing experts and thus may be of little value in resolving the issue.

[12] *See, e.g.*, *Bristol-Myers*, *supra* note 8, at 320; *Horizon Corp.*, 97 F.T.C. 464, 810 (1981).

Complaint Paragraph Number	Alleged Representation
12(a)	Aspercreme is an effective drug for the relief of minor arthritis and its symptoms.[13]
12(b)	Aspercreme is as effective a drug as orally-ingested aspirin for the relief of minor arthritis and its symptoms.
12(d)	Aspercreme is an effective drug for the relief of rheumatic conditions and their symptoms
12(e)	Aspercreme acts by directly penetrating through the skin to the site of the arthritic disorder.[14]

Because Thompson has acknowledged making the above-listed representations, we may state without reviewing the ads that Thompson intended to make these claims. Therefore, it is reasonable to interpret the ads as making them. [12]

Thompson has not acknowledged making any of the other representations listed in the complaint. We therefore examine each of these alleged representations in turn to determine whether or not consumers acting reasonably under the circumstances would interpret Thompson's advertisements as making them.

2. *Aspirin Content—Paragraphs 10(a), 16.*

Of all the disputed representations, the one that received the most attention at trial was the issue of whether or not Thompson's advertising, and specifically the trade name "Aspercreme" represented that the product contains aspirin. Complaint counsel argued that it did, *i.e.,* that it represented Aspercreme to contain a cream form of acetylated salicylate, as aspirin is defined in the United States Pharmacopoeia. Thompson argued that the ads merely suggest Aspercreme is a drug which works like the more familiar aspirin, not that it actually contains aspirin (RAB 41). Thompson also argued that consumers understand the word "aspirin" as a generic reference to the class of drugs that are pain killers, not to the particular salicylate contained in aspirin tablets (RAB 35–36). Thus, the issues presented for our consideration here are, first, whether one net impression it is reasonable to interpret Thompson's ads as conveying to consumers is that Aspercreme contains aspirin and, second, what consumers would interpret the word "aspirin" to mean in the context of the Aspercreme ads. [13]

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[13] In acknowledging that it made this claim for relief of arthritis, Thompson denied representing that Aspercreme will cure the disease. Thompson similarly denied representing that Aspercreme will cure rheumatism. The ALJ found that Thompson had not made such representations (IDFs 131–32, 141–42).

[14] We note that the complaint included another allegedly deceptive representation. Complaint Paragraph 12(f) charged Thompson with representing that Aspercreme does not result in the adverse reactions associated with aspirin. The ALJ concluded (IDF 143) that in the context of Thompson's advertisements, the statements about "no" side effects would be taken to mean "no *significant*" side effects, for which representation Thompson had a reasonable basis. Accordingly, the ALJ dismissed so much of the complaint as relates to Paragraph 12(f). We agree with the ALJ's disposition of this part of the complaint.

We note to begin that none of the Aspercreme ads includes an express representation that Aspercreme contains aspirin. On the contrary, like much advertising we find deceptive, the ads are drafted with an artful choice of words to make what Thompson thought were literally correct statements (for example, that Aspercreme's pain relieving properties are equivalent to aspirin's). However, in considering the net impression of an advertisement, we do not require that all consumers reading or viewing it be sophisticated experts in interpreting the nuances of the English language. Absent reason to conclude differently, we presume that advertisements are directed at ordinary members of the adult population who, as such, have a range of abilities.[15] We look at how such [14] individuals actually interpret advertisements in real-life situation, not at how they would if they had sufficient time and incentives attentively to review the ads so as to come up with the most semantically correct interpretation of them. We therefore consider here whether one message impliedly conveyed to reasonable consumers by the ads is that Aspercreme contains aspirin. To do this, we need to evaluate the ads' net impression on consumers. The ads are not all alike; rather they fall into several different groups. We describe each group below and consider whether it gives a net impression of aspirin content.[16]

(1) The TV Ads With No Disclosures—CXs 1 and 2

Thompson's earliest television ad for Aspercreme, CX 1, shows a woman talking. As the ad begins, she is shown holding two aspirin tablets and saying ". . . imagine being able to put the strong relief of aspirin right where you hurt most." At this point, the two aspirin tablets in her hand disappear and are replaced by a tube of Aspercreme, while she says: "Now, with amazing Aspercreme, you can get the strong relief of aspirin directly at the point of minor arthritis pain." She continues comparing Aspercreme to aspirin, noting (among other things) that Aspercreme contains none of aspirin's side effects. As the ad ends, she leaves the screen and is replaced by a still life [15] showing a tube and bottle of Aspercreme, along with a video super stating: "The strong relief of aspirin right where you hurt." The audio portion of the ad concludes with a voice over stating the same phrase as the video super.

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[15] If advertisements are targeted at special audiences who as a group have a greater or lesser capability to recognize deceptive advertising than ordinary members of the adult population or a distinctive reaction to particular advertising claims, a reasonable consumer is an ordinary members of that target audience. *See, e.g., Travel King*, 80 F.T.C. 715 (1975). However, almost all advertising is targeted at some demographic group, such as farmers, housewives, or residents of a particular area. This alone does not mean that we apply a standard different from our customary one.

Previous Commission cases have recognized that persons with health-related problems can be a target audience. *See, e.g., Travel King, id.; Porter & Dietsch*, 90 F.T.C. 770, 864–65 (1977), *aff'd*, 605 F.2d 294 (7th Cir. 1979), *cert. denied*, 445 U.S. 950 (1980). In this case, Thompson's ads were directed at arthritics. The ALJ's opinion (IDF 90) suggests that he considered arthritics to be a target audience. Though his finding was stated in conclusory fashion, other available evidence and findings (such as the fact that arthritis is a chronic disease (IDF 191) and that consumers spend significant amounts of money on quack remedies (IDF 193) suggests that arthritics may be more susceptible to deceptive analgesic claims than ordinary members of the adult population and therefore are a target audience. Ultimately we find it unnecessary to resolve the question because the evidence in this proceeding shows that Thompson's ads were deceptive whether or not arthritics are considered a target audience.

[16] Our discussion here focuses solely on the advertisements Thompson used in the national consumer advertising campaign for Aspercreme (CXs 1–11, 21–22, and 37). We do not evaluate the Aspercreme ads in the local Ohio market (CXs 12–20) because our conclusions about the national ads makes it unnecessary to do so.

The second early Aspercreme ad, CX 2, is similar to CX 1 at its beginning and end. To begin, it shows a woman holding two aspirin tablets. As she holds the tablets, she tells listeners to "imagine putting the strong relief of aspirin right where you hurt." Next an Aspercreme tube replaces the two tablets, whereupon she states: "Aspercreme is an odorless rub which concentrates the relief of aspirin." At this point, CX 2 diverges from CX 1. In its middle portion, CX 2's visual part uses the transparent outline of a man's body and rays streaming outward from both an aspirin tablet in the stomach and a point on the shoulder where Aspercreme was rubbed. There are fewer rays from the stomach than from the shoulder. As the rays are shown visually, the woman states that "regular aspirin . . . goes through your body like this [through the stomach]. But, in seconds, Aspercreme starts concentrating all the temporary relief of two aspirin directly at the point of minor arthritis pain." The ad concludes with the same still life and audio as does CX 1. [16]

The ALJ concluded that a variety of different elements in these ads were representations that Aspercreme contains aspirin.[17] Among the elements were use of the brand name "Aspercreme," repetition of the words "Aspercreme" and "aspirin" in the same commercial, use of the statement that Aspercreme provides "the strong relief of aspirin" and the visual image in which two aspirin tablets are replaced by a tube of Aspercreme (IDFs 85-89).

Our own examination of the net impressions conveyed by these ads also causes us to conclude that they suggest that Aspercreme contains aspirin. We agree with the ALJ's view that various elements in the ads suggest aspirin content. We further note the absence of any elements giving a contrary impression, such as express disclosures. Therefore, all the evidence from the ads themselves points to one conclusion: that the ads are likely to give consumers interpreting them reasonably a net impression that Aspercreme contains aspirin.

Although we do not find it necessary from our perspective to look at extrinsic evidence in evaluating CXs 1 and 2, Thompson has offered some in support of its theory that consumers would interpret CXs 1 and 2—and all the other Aspercreme ads, as well—to mean that Aspercreme provides relief like aspirin [17] without actually containing aspirin as an ingredient (RPF 240–60). Because Thompson offered extrinsic evidence, we are obliged to consider it. However, our review of Thompson's evidence does not change our views regarding CXs 1 and 2.

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[17] The ALJ did not distinguish between express and implied representations. He also did not focus separately on the net impression given by CXs 1 and 2. Rather, he analyzed whether or not individual words, phrases, or visual images used in one or more of Thompson's ads implied aspirin content. As we noted in the text, above, our method of analysis looks at the net impression created by the interaction of different elements in a given ad, not at the elements by themselves.

One type of extrinsic evidence offered by Thompson consisted of testimony by marketing experts. (*See, e.g.,* Ross, Tr. 5983–88; Jasper, Tr. 4736; Silver, Tr. 5654–55) and the results of a consumer survey, the Video Storyboard Test (RX 165). Having examined the testimony, we find it unpersuasive.[18] [18]

Thompson also has claimed that the results of the Video Storyboard Test (RX 165) show that CXs 1 and 2 do not leave a net impression of aspirin content with consumers who interpret the ads reasonably. The Video Storyboard Test is, of course, consumer survey research, and as such is the type of evidence to which we would give considerable weight if it were methodologically sound. However, we agree with the ALJ's conclusion (IDF's 117–19) that the Video Storyboard Test was improperly designed for the objective of providing data on whether CXs 1 and 2 communicate a net impresssion of aspirin content to consumers.

Although the report of the Video Storyboard Test does not include a protocol describing what the study was designed to measure and how the methodology chosen would do so (in and of itself a factor we view negatively when assessing the quality of a study), it appears that the survey was designed to measure the comparative effectiveness of CX 1 and CX 2 in conveying important attributes of Aspercreme to potential users (RX 165A-M). In order to collect this information, the Video Storyboard Test used a shopping mall intercept sample to obtain 100 participants. The respondents were qualified by age, *i.e.,* 45 years and older, and by whether they "occasionally have symptoms of arthritis" (CX 165–O). Fifty participants were shown CX1 and the other fifty viewed CX 2. Immediately after viewing either CX 1 or CX 2, participants completed the survey questionaire.

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[18] For example, Thompson's principal marketing expert, Dr. Ross, speculated on whether the percentage of consumers coming away from CXs 1 and 2 with the impression that Aspercreme contains aspirin rose above an "irreducible minimum, but he provided little factual or analytical support for his observations." *See e.g.,* Tr. 5985–86:

> Q. Is it possible, Dr. Ross, that some consumers might have taken away the impression from CX–1 that Aspercreme is aspirin?
>
> A. Yes, I think it is possible. I think that some may have and I think that that impression would occur simply from the analogy between Aspercreme and internal analgesics. That is, some may think if it relieves the same way, it is aspirin.
>
> But I think that is a kind of irreducible minimum percentage kind of thing of a perception, of a misperception, in that I think if you are going to compare any external rub product to any internal product, any internal analgesic product, that some are going to assume that you mean aspirin, since that is the word that they use for such internal tablets or product.
>
> So, in perceiving that the ad is representing that Aspercreme has aspirin, all the consumer is really thinking or saying is that it has an analgesic in it.

Although the sample was a non-probability sample (*i.e.*, its results are not projectable to the national population as a whole) and rather small, there is no apparent reason why the [19] persons surveyed would not be reasonably representative of a typical subset (those over 45 who suffer occasional symptoms of arthritis) of those persons who generally might be interested in purchasing analgesics to relieve arthritis pain. However, CX 51 does not provide probative information about the participants' beliefs about aspirin content in Aspercreme for two reasons. First, it does not contain any questions that directly elicit ingredient information. Second, the verbatim responses were not placed on the record and the data from the study were not coded to determine the percentage of responses that included mentions of ingredients (Ross, Tr. 6310). The questionnaire used in the Video Storyboard Test was concerned with the persuasiveness of each commercial (question 1), the impact of the messages or copypoints in each commercial (questions 2, 3, 4, 9, 10, 11 and 12), the perceived uniqueness of Aspercreme (questions 5 and 6), the relative effectiveness of Aspercreme compared to aspirin (questions 7 and 8), and demographics (age and sex of respondents). The way in which these questions were phrased makes any information provided about ingredients in general, and aspirin content in particular, incidental to the information gathered about the relative effectiveness of CX 1 and CX 2 as commercials. Of course, some participants nonetheless may have mentioned ingredients in their responses to the questions being asked. If the record contained information showing how many participants gave such responses, we would examine whether enough had done so to make the results reasonably reliable. However, no [20] such information was supplied with CX 51. Therefore, we find that CX 51 is of no probative value in determining the consumers' beliefs about whether Aspercreme contains aspirin.

While we thus find the extrinsic evidence relied on by Thompson not to be probative, we find that complaint counsel's evidence does not provide extrinsic evidence consistent with the conclusions we reach from analyzing the ads themselves. Complaint counsel cite to the Mapes and Ross Test (CX 50), which was conducted for Thompson in 1979, prior to the start of this litigation. Although Thompson now criticizes the design of this survey (RAB 53–54), we find that its methodological strengths far outweigh its weaknesses. Specifically, its research methodology (or close variants of it) is frequently used in copytests. For example, the use of prerecruited groups of subjects, lotteries to provide incentives for viewing, the attempts to "bury" the commercials in programmatic material, and day-after unaided recall, aided recall and brand preference measures are typical of advertising copytests. In addition, although the study did not employ a probability sample and discussed neither survey response rates nor non-response bias, we cannot detect any obvious reason why the sample is not reasonably representative of consumers viewing CXs 1 and 2. Such methodology is adequate for the results to be of some probative value, assuming the survey asked probative questions.

Like the Video Storyboard Test, the Mapes and Ross survey contained questions that attempted to elicit participants' recall of the information contained in CX 1 and CX 2 and did not contain direct questions about ingredients. However, unlike the Video [21] Storyboard Test, the Mapes and Ross final report contains the verbatim responses provided by the participants so that the percentage of respondents who mentioned aspirin as an ingredient can be determined. From the resulting responses come two estimates of the percentage of relevant market females who, given one exposure to a televised Aspercreme commercial, perceive that Aspercreme contains aspirin. The first estimate is contained in the Mapes and Ross final report, which calculates the percentage of survey participants who thought Aspercreme "Works Like/Contains Aspirin" after viewing CX 1 or CX 2. The second estimate is contained in a memo from an Ogilvy and Mather researcher who reviewed the verbatim transcripts of the data collected in the study and independently calculated the percentage of respondents who believed Aspercreme contained aspirin (CX 116–A). The data from both sources are provided below:

Table 1

Respondents Perceiving:	**CX–1 Visible Man %**	**CX–2 Stand-Up Presenter %**
Aspercreme "Works Like/Contains Aspirin" (CX50–H)	23	35
Aspercreme product contains aspirin-recallers only; (Oglivy and Mather memo, CX116–A)	21	30 [22]

Although there are some biases in the Mapes and Ross Test,[19] its results support our conclusion that one reasonable interpretation consumers would make of these two ads is that Aspercreme contains aspirin.

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[19] The test contains several potential sources of bias which may have affected the estimate of the percentage of people who believe Aspercreme contains aspirin. On one side, the screening process used to obtain the sample may have alerted participants about the nature of the study. If so, respondents would have paid more attention to the commercials than they otherwise might have. On the other side, one exposure to the advertisements is less than the three recommended for maximum recall and comprehension in a natural viewing situation. *See* H. Krugman, *Why Three Exposures May Be Enough*, Journal of Advertising Research, Dec. 1972, 11–14. The omission of aided questions or probes about ingredients probably caused the estimates of the proportion of respondents believing that Aspercreme contained aspirin to be understated.

Thus the Mapes and Ross Test, the only reasonably reliable extrinsic evidence regarding CX 1-2, supports our conclusion that it is reasonable for consumers to interpret CXs 1 and 2 as making an implied claim of aspirin content.

(2) The TV Ads With Visual Disclosures—CXs 3 and 4

The next two Aspercreme television ads, CXs 3 and 4, are essentially similar to the earlier ads, CXs 1 and 2 respectively, with one difference. Both CX 3 and CX 4 have video supers that read: "contains no aspirin." Thus, the question presented by CXs 3 and 4 is whether the video supers are sufficiently clear [23] and conspicuous to overcome the impact of other elements in the ads, elements which caused somewhere between 21% and 35% of the persons viewing CXs 1 and 2 to believe that Aspercreme contains aspirin.

The extrinsic evidence relating to CXs 3 and 4 is not of the sort we perfer to rely on in evaluating the possible existence of implied claims, but is sufficient for us to reach the conclusion that the ads' net impression upon reasonable consumers is one of aspirin content. There is no survey research pertaining directly to CXs 3 and 4, and we are not persuaded by the expert opinions presented at trial as to what consumers would interpret the ads to mean (*See* Cohen, Tr. 213-18; Ross, Tr. 6016-18, 6185-98) because we find them to be inadequately supported.[20] However, copy testing performed on an Aspercreme ad with what appears to be a more prominent disclosure of non-aspirin content, CX 9, found that one net impression given to consumers was that the [24] product contains aspirin.[21] CX 9 was sufficiently similar to CXs 3 and 4 that we consider it permissible to infer from the CX 9 results that an even higher percentage of consumers would come away with such a net impression after watching CXs 3 and 4.

Additional extrinsic evidence in the form of generally recognized marketing principles also leads to the conclusion that the disclosures were insufficiently clear and conspicuous. The disclosures were placed in the middle of the ads and were distracted from by the conceptually uncorresponding audio message being communicated while they were on the screen. Studies of consumer behavior show that individuals will better remember either information presented to them first (primary effect) or information presented to them last (recency effect), depending upon the delay between presentation of the messages and evaluation of the recipients' responses. In any event, however, recall typically is a U-shaped function, with the worst recall being of messages presented in the middle. A distracting situation lowers ability to recall at all points along the curve.[22] [25]

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[20] The ALJ's initial opinion also cites the views of CBS and the National Association of Broadcasters (NAB) that the disclosures were inadequate as evidence that the disclosures were so. The opinion does not clearly alert readers to the ALJ's ruling at trial (Tr. 637) that the opinions of CBS and NAB were to be admitted into evidence not as primary evidence, but only as confirmatory evidence (Tr. 637). (The opinion does describe the CBS and NAB views as "confirmatory", but fails to indicate that the word has any special significance.) We agree with the ALJ's view at trial that this evidence cannot be relied on to establish in the first instance whether or not the video supers were adequate. As was argued by Thompson (Tr. 633-36), the record does not show the qualifications of the individuals at CBS and NAB who reached the conclusion that the supers were inadequate, the facts that were before these individuals, or the standards they applied to the facts. However, we see no logical basis for the ALJ's decision to use these opinions as "confirmatory" evidence and, accordingly, do not rely upon them ourselves.

[21] *See* our discussion of CX 9, below at pp. 33-42.

(3) The Print Ads With Common Headlines—CXs 6–7, and 10–11.

Six print ads for Aspercreme were introduced into evidence in this proceeding. Four of them, CXs 6–7 and 10–11, have common elements. Principal among these is an identical headline. The ads begin in large print:

> At last! A remarkable breakthrough
> for arthritis pain: Aspercreme.

Below this and in smaller print, the headline continues:

> Aspercreme is an effective arthritis medicine
> which concentrates all the strong relief of aspirin
> directly at the point of pain.

All four ads also contain a visual representation of an Aspercreme tube and bottle. Both display the brand name "Aspercreme" and the statement, "external arthritic pain medication."

Two of the ads, CXs 6 and 7, have additional elements that would contribute to their net impression concerning aspirin content. Below their headlines, each shows a drawing of a man's body, with numbered lines pointing to various body parts. Associated with each line is text in smaller print that the headlines. CX 6's text compares Aspercreme to aspirin in two ways: (1) "Aspirin tablets go through your body. But Aspercreme concentrates the relief of an effective aspirin-like analgesic [26] directly at the point of arthritis pain . . ."; and (2) "Aspercreme, like aspirin itself, has no liniment smell." CX 7's text has three comparisons between Asprecreme and aspirin: (1) "Aspirin tablets go throughout your body. But Asprecreme concentrates the relief of two aspirin directly at the point of arthritis pain . . ."; (2) "Aspercreme works faster than aspirin because you rub it right where you hurt"; and (3) "Aspercreme, like aspirin itself, has no liniment smell."

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[22] *See* B. Sternthal and C. Craig, *Consumer Behavior, An Information Processing Perspective* 102–03, 282–83 (1982) and works cited therein.

We conclude that it would be reasonable to interpret all four print ads as conveying a message of aspirin content. For three of the ads, CXs 7, 10–11, we reach this determination based solely upon our examination of evidence from the ads themselves. In particular, we conclude that the language in the headline ("Aspercreme . . . concentrates all the strong relief of aspirin . . .") is readily susceptible to the interpretation that Aspercreme contains aspirin and that the language would be so interpreted by consumers. Given this fact, and given that no other elements in these ads suggest other than that Aspercreme contains aspirin, we conclude that at least one of the net impressions communicated by the ads is of Aspercreme's aspirin content.

One of the ads, CX 6, does include textual language amounting to an implied representation that Aspercreme does not contain aspirin. It states: "Aspercreme concentrates the relief of an effective aspirin-like analgesic . . ." The most direct conclusion to draw from a statement that Aspercreme is "like" aspirin would be that it is similar to but not the same as aspirin. Because this element in the ad conflicts with the [27] element stating that Aspercreme "concentrates all the strong relief of aspirin," we require something in addition to evidence from the ad itself before determining whether or not consumers would interpret CX 6 to state that Aspercreme contains aspirin.

The additional element in the case of CX 6 is the general marketing principle, acknowledged by Thompson's marketing expert (Ross, Tr. 6198–99) as well as complaint counsel's (Cohen, Tr. 223), that persons reading a print ad often will read only the headline, and will take their sole impression of the ad from it. The special significance of headlines has previously beeen recognized in Commission cases, which hold that even an express disclosure in the text of an ad may not be enough to change the ad's net impression upon consumers.[23] Applying this principle to CX 6, complaint counsel's marketing expert testified that a great many people reading CX 6 would believe Aspercreme to contain aspirin (Cohen, Tr. 233).[24] We also find that application of the general principle to this specific situation suggests such a [28] result. Upon this basis, we conclude that one net impression consumers reasonably would understand CX 6 to be conveying is that Aspercreme contains aspirin.

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[23] *See, e.g., Litton Industries, Inc.,* 97 F.T.C. 1, 70 n.5 (1981); *Giant Food, Inc.,* 61 F.T.C. 326, 348–49 (1962), *aff'd,* 322 F.2d 977 (D.C. Cir. 1963), *cert. denied,* 376 U.S. 967 (1964).

[24] Thompson's marketing expert argued that the headline itself does not imply aspirin content (Ross, Tr. 6020–21, 6060–61), from which it would follow that persons reading the headlines alone would not believe Aspercreme contains aspirin. While we are obliged to consider this opinion because it was offered as evidence, we find it unpersuasive.

(4) The Other Print Ads—CXs 8, 37.

The other two print ads, CXs 8 and 37, are different from the other four and from each other. We first examine CX 8.

Beginning with its headline, CX 8 repeatedly contrasts Aspercreme with aspirin. The headline states:

> There's always been aspirin . . .
> Now there's ASPERCREME[25]
> Works faster, safer than aspirin—relieves pain in minutes.

The first sentences of the text, (in considerably smaller print than the headline) continue this comparison approach by stating: "Aspirin has been helping sufferers of minor arthritis pain for years. Now there's a different way to get relief. ASPERCREME." Other comparisons in the text similarly contrast Aspercreme with aspirin. In addition, there is a visual depiction of an Aspercreme tube in its display packaging. Visible on the display packaging, in print slightly smaller than the text of the ad, is the statement: "An effective aspirin-like analgesic for temporary relief of occasional minor pain . . ." [29]

We are not able to conclude with adequate confidence by looking solely at evidence from the ad itself whether or not one message conveyed to consumers by CX 8 is that Aspercreme contains aspirin. The general tone of the ad contrasts Aspercreme with aspirin, emphasizing the supposed difference between the products rather than their similarities.[26] These contrasts might create among average consumers the impression that Aspercreme is different from aspirin. On the other hand, it might also be that the perceived difference would be means of application (external rather than internal), not identity of active ingredients.

In this situation, we cannot find the ad to convey an implied message without sufficiently probative extrinsic evidence upon which to base our conclusions. We do not find any such evidence here. There was no consumer survey research on CX 8 or any other Aspercreme advertisement similar enough to CX 8 to permit the drawing of inferences about CX 8 from it. The testimony of the marketing experts also does not permit us to reach reasonably confident conclusions. Complaint counsel's principal marketing expert argued that most people looking at a newspaper ad such as CX 8 would only look at the headline, which links Aspercreme with aspirin (Cohen, Tr. 226), but he did not show that the link created by such a headline would equate Aspercreme and aspirin; instead, consumers might interpret the link to suggest that Aspercreme is a new product similar to but [30] different from aspirin.[27] Thompson's principal marketing expert, on the other hand, emphasized the fact that CX 8 contrasts Aspercreme with aspirin, concluding from this that if consumers understand aspirin as a specific ingredient, the headline would communicate that Aspercreme is not aspirin (Ross, Tr. 6026–27). However, he provided no evidence to exclude a possible consumer interpretation of the headline that Aspercreme provides the clinically active ingredient of aspirin tablets in a cream form. While both sides have thus failed to present adequate extrinsic evidence concerning CX 8, the burden was on complaint counsel to do so. In light of that failure, we cannot find CX 8 to contain an implied message of aspirin content.

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[25] This part of the headline is in significantly larger print than other parts.

[26] The other Aspercreme ads we have reviewed up to now emphasized similarities, *e.g.*, "aspirin's relief."

We next turn our attention to the remaining print ad, CX 37. The headline of CX 37 characterizes Aspercreme as "a remarkable analgesic" and as "an effective alternative to pills for minor arthritis pain." The first paragraph of the text, which is in bolder print than the remainder, states: "Aspercreme contains salycin, an effective *non* -aspirin pain reliever that concentrates relief right at the point of pain. You get hours of relief without the side effects pills may cause." Further on, the text additionally states: "Aspercreme has a *non*-aspirin pain reliever, so it can't cause aspirin's stomach upset or any of aspirin's side effects" and "Aspercreme's active pain reliever—[31] *salycin*—is clincally proven . . ." (emphasis in original). All of these elements suggest a difference between the active ingredient in Aspercreme and the active ingredient in aspirin. Nor is there any element in the ad except for the brand name that even arguably could be viewed as implying that Aspercreme and aspirin are the same. It may be that the brand name alone would be enough to convince some readers that the product contains aspirin, and that the disclosures would be insufficient to overcome this misimpression. However, we would require that such a conclusion be supported by extrinsic evidence.

Our conclusion diverges from the ALJ's, who found that CX 37 did represent aspirin content (IDF 84). However, the ALJ's discussion of this particular ad is flawed by his analytic approach, which was to look at each element that was in one or more ads and then to decide whether or not the element, considered by itself, represented aspirin content. Not only do we believe this approach to be less analytically desirable than considering the net impression which different elements in an ad combine to give, but in this case the approach caused the ALJ to lump CX 37 together with several of Thompson's television advertisements, all of which are quite different from CX 37. Thus, the

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[27] We will not presume generally that consumers interpreting advertisements reasonably under the circumstances will always read a comparative ad to imply that the products being compared are the same. For example, we seriously doubt that persons reading "Buy a racing car. It provides faster, more enjoyable transportation than a station wagon." would interpret the ad to imply that the products were the same.

ALJ incorrectly wrote that the affirmative statements in several ads, including CX 37, were required by the television networks. Obviously, the networks had no control over print ads such as CX 37. Likewise, where the ALJ cited extrinsic evidence as to why the affirmative statements in various ads were ineffective disclosures (IDF 84), the evidence itself pertained only to the television advertisements, not to CX 37 [32]

The one point made by the ALJ that appears specifically to apply to CX 37 is his observation that the phrase "contains salycin, a non-aspirin pain reliever," found in both CX 37 and several television ads, is ambiguous because it does not negate the impression that Aspercreme may contain *both* aspirin and "salycin." We find this point unpersuasive for two reasons. First, while it is literally true, as a nicety of English semantics, that the statement "contains salycin" would not absolutely negate the possibility that Aspercreme also contains aspirin, nothing in CX 37 expressly states that Aspercreme has more than one active ingredient. Nor do we find that the brand name "Aspercreme" or any other element in CX 37 implies the product contains two active ingredients.[28] Therefore, in considering how consumers probably would interpret the ad, rather than how it is technically possible for someone to read it, we find it irrelevant that the statement in CX 37 does not specifically exclude the possibility of two active ingredients. Second, even if one thought average adults were sticklers for English semantics, there is a statement in CX 37, one which the ALJ overlooked, that does negate the possibility of aspirin content. It is the statement that Aspercreme's "active pain [33] reliever" is salycin. Since the ad refers to "pain reliever" in the singular, it excludes the possibility of there being a second active ingredient.

(5) The TV Ads With Audio Disclosures—CXs 5, 9 and 21–22

The most recent television ads for Aspercreme, the ones on which most of the Aspercreme advertising dollars were spent (CX 25A), contain audio disclosures that either expressly or impliedly state that Aspercreme does not contain aspirin. Three of the ads, CXs 5, 9 and 21, are testimonials whose main focus is to show various men and women endorsing the product. Among the individuals' statements are those that Aspercreme relieved their arthritis, did not upset their stomachs, was odorless, or relieved their pain for hours. These ads do not mention the word "aspirin," liken Aspercreme's relief to that provided by aspirin, or liken Aspercreme to "pills." Each also contains a disclosure in a middle frame of the ad (rather than at its beginning or end) stating that Aspercreme does not contain aspirin. In CX 5, it is the express audio statement "aspirin free," coupled to a visual image of an Aspercreme tube. In CXs 9 and 21, it is the statement "Aspercreme contains salycin, a strong non-aspirin pain reliever." coupled to the visual image of an Aspercreme tube and the video super "contains salycin."

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[28] The name "Aspercreme" may imply that Aspercreme contains aspirin as an active ingredient. However, the name does not suggest whether or not the product has more than one active ingredient.

In the remaining TV ad, CX 22, a woman compares Aspercreme with "pills," stating that Aspercreme provides long lasting relief without the side effects pills may cause. Insofar as "pills" is an implied reference to aspirin tablets, CX 22 is an [34] ad that contrasts the two forms of medication. In the middle frames of the ad the woman states "Aspercreme relieves arthritis pain because it contains salycin, a strong non-aspirin pain reliever." while the visual portion of the ad shows her applying Aspercreme to the back of one of her hands.

We would not find CXs 5, 9 and 21–22 to convey an implied aspirin content message if we were to rely solely upon an examination of evidence from the ads themselves. The contradictory elements in these ads preclude us from determining with sufficient certainty what message(s) viewers would take away from the ads concerning the aspirin content of the product. On the one hand, there is the disclosure that Aspercreme contains a non-aspirin pain reliever, coupled to the absence of any language or visual imagery likening the product to aspirin tablets. On the other hand, there is the "Aspercreme" brand name itself. The brand name was visually displayed in each ad, as well as being repeated beween four and six times on the ads' voice tracks. Moreover, the brand name of a product is the most powerful single stimulus in an ad. Consumers are more likely to recall brand names than specific copy points in advertisements (Cohen, Tr. 559; Ross, Tr. 6317–19). A net impression based primarily upon a message derived from the brand name could be that Aspercreme contains aspirin.

In this situation, we require extrinsic evidence to help us determine how reasonable consumers actually perceive the ads. The record contains three surveys that we believe shed light on the question of what consumers believe CX 9 to mean: the FRC Test (CX 35/RX 520), and the Lieberman Test (CX 32/RX 500), which [35] were both sponsored by Thompson, and the ASI Theater Test (CX 27), which was sponsored by complaint counsel. The results from each of these studies and significant details about their methodologies are summarized below. However, the conclusion we draw from the surveys can be stated at the outset: consumers interpreting CX 9 reasonably could and did think that Aspercreme contains aspirin.

(a) *The FRC Test (CX 35/RX 520) and the Lieberman Test (CX 32/RX 500)*

In 1981 Davis and Gilbert, Thompson's counsel, contracted with Ken Warwick and Associates, Inc. to design a copytest of CX 9. Based on background information contained in the FTC complaint and discussions with Davis and Gilbert, Warwick designed and conducted the FRC copytest (CX 35/RX 520). After the FRC study was completed and the results were in, Warwick redesigned the survey questionnaire used in CX 520 and completed a second study, the Lieberman copytest (CX 32/RB 500).

Both the FRC and Lieberman studies were intended to determine the percentage of respondents who, after viewing CX 9, believed Aspercreme contained aspirin. The methodology was the same for both studies and involved showing respondents, who were recruited and screened with shopping mall intercepts, the advertisement CX 9 and asking them a short series of questions. Respondents were shown CX 9 twice and no distracting materials such as other ads were included. This methodology increases the probability that respondents paid attention to CX 9. Thus, if [36] there was any bias in the methodology used in the Warwick studies, it was in the direction of increasing the percentage of respondents who remembered the information presented in CX 9.

Although there were few differences in the research design between the FRC and Lieberman studies, there were important substantive differences in the survey questionnaires used in each study. The questionnaire in the first study contianed four questions probing consumer perceptions as to the ingredients of Aspercreme and two other analgesic rubs:

> Q1. First, what was the name of the ingredient in the product you just saw advertised?
>
> Q2. Based on the commercial you just saw, does the product in the commercial contain aspirin?
>
> Q5. Does Ben-Gay contain aspirin?
>
> Q6. Does Mentholatum contain aspirin? (RX 520; Warwick, Tr. 5332)

The second study contained only one question probing such consumer perceptions:

> Q1. What was the name of the ingredient in Aspercreme, the product advertised? (RX 500-E)

Findings from the FRC and Lieberman studies are summarized in Table 2: [37]

Table 2
Unaided and Aided Recall Results to Questions About the Ingredients in Topical Analgesics

Ingredients Mentioned With Unaided Recall	**FRC Survey Question 1***	**Lieberman Survey Question 1****
Salycin	95 (45.9%)	(25%)
Aspercreme	43 (20.8%)	(2%)
Aspirin	6 (2.9%)	(5%)
Blank/Don't Know	47 (22.7%)	(65%)
Others	16 (7.7%)	(3%)
n (totals)	207 (100%)	212 (100%)

Aided Recall Perception of Whether Aspirin is an Ingredient in...*	**FRC Survey** **Yes**	 **No**	 **Don't Know**	 **Total**
Aspercreme (question 2)	22.2%	67.6%	10.1%	99.9%
Ben-Gay (question 5)	6.3%	39.1%	54.6%	100.0%
Mentholatum (question 6)	4.8%	43.5%	51.7%	100.0%

*RX 520–G
**Warwick, Tr. 5321.

The results from the unaided recall questions (the first question contained in each survey) indicate that between 25 and 46 percent of the participants identified Salycin as the ingredient in [38] Aspercreme.[29] Thus, less than half of the respondents were able to provide this response after seeing the commercial twice. However, in both surveys very few of the respondents mentioned aspirin as an active ingredient in Aspercreme. Thus, the unaided recall question in both surveys tends to support Thompson's position.

The results from the aided recall questions in the FRC survey (questions 2, 5 and 6) tell an entirely different story. That is, when queried directly about whether Aspercreme contains aspirin, 22 percent of the respondents replied affirmatively. Conversely, only 6 percent of the respondents thought aspirin was an ingredient in Ben-Gay and less than 5 percent perceived that aspirin was contained in mentholatum.

These results show that CX 9 did, in fact, cause average viewers to believe that the product being described contains aspirin. Specifically, the difference in the response percentages between Aspercreme, on the one hand, and Ben-Gay and Mentholatum, on the other, allows us to conclude with reasonable [39] confidence that the results of the FRC Test were not caused by survey bias. The questions about the content of Ben-Gay and Mentholatum acted as controls for the survey, and permitted an estimate of the "noise level" generated by various possible random factors, such as confusion on the part of consumers being surveyed or "yeasaying bias" in response to aided questions.[30] The significant difference between the percentage of consumers who thought Aspercreme contains aspirin and those who thought it was contained in the other rubs clearly supports the conclusion that CX 9 generated a net impression of aspirin content among its viewers.[31] [40]

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[29] No information is contained in the record explaining why the percentage of respondents who identified Salycin as the active ingredient in Aspercreme varied so dramatically between the FRC and Lieberman studies. Although the wording of the unaided recall question (Q1) was changed between the two surveys to decrease the percentage of participants who responded "Aspercreme" (Warwick, Tr. 5325), there is no reason to expect that this change would influence the percentage of "Salycin" responses. We would expect that the change in wording in question 1 between the FRC and Lieberman studies would reduce the percentages of participants giving the response "Aspercreme" from 20 to close to 0 percent and cause a corresponding increase in "don't know" responses, *e.g.*, from 23 to 43 percent. What we find is that the Lieberman study obtained roughly the decline expected in Aspercreme responses, *i.e.*, from 20 to 2 percent, 20 percent more "don't know" responses, and 20 percent less Salycin responses than expected based on the FRC results.

(b) *The ASI Theater Test (CX 27)*

The effectiveness of the disclosure in CX 9 that aspirin is not an ingredient in Aspercreme was also examined in the ASI Theater Test (CX 27) sponsored by complaint counsel. The methodology involved recruiting two groups of subjects to a theater for the ostensible purpose of evaluating a pilot television show. Each group of subjects was shown the same "pilot" show, a standard control commercial for Papermate Flair pens and one of two topical analgesic commercials, *i.e.*, one for Aspercreme and one for Mobisyl (CX 27–E). The next day as many viewers as could be contacted were telephoned and asked unaided and aided recall questions about the products advertised in the theater test and the ingredients they might contain (CX 27–E-H).

It is likely that the responses to the ASI Theater Test show a bias toward relatively increased estimates of the confusion about the information contained in CX 9. This is due to the fact that CX 9 was shown only once, that it was shown along with programmatic material and another commercial, and that participants were not asked questions about the ingredients in these topical analgesics until the next day. Thus, it is likely that the ASI Theater Test resulted in an inflated estimate of the percentage of respondents who, as a result of CX 9, believe aspirin is an ingredient in Aspercreme (or conversely, a deflated estimate of the effect of the affirmative disclosure that Aspercreme does not contain aspirin). The results from the unaided and aided recall questions contained in the ASI Theater Test are shown in Table 3 below: [41]

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[30] If roughly no more respondents had answered that Aspercreme contains aspirin than answered that Ben-Gay or Mentholatum did, we would conclude that the extrinsic evidence did not show CX 9 to give a net impression of aspirin content. However, three times as many respondents perceived Aspercreme to contain aspirin even after twice viewing a disclosure to the contrary, than perceived that aspirin was an ingredient in Ben-Gay or Mentholatum.

[31] Dr. Warwick, the expert who originally designed the FRC Test for Thompson, argued that it was flawed through use of aided recall questions and that this is the reason why he designed a second test omitting them. However, we agree with the ALJ's observations (IDF 109) on why the second study, the Lieberman Test, omitted the aided recall questions found in the earlier study:

> Although Dr. Warwick testified that this was an improvement over the FRC Test design, which he characterized as "flawed," the evidence is also consistent with the conclusion that the direct ingredient question was dropped because it had produced results unfavorable to Thompson in the FRC Test.

Dr. Warwick's testimony to the contrary is unpersuasive in light of the fact that the aided recall questions are widely used in advertising research and the fact that there are numerous ways of reducing the yeasaying bias Dr. Warwick argued such questions can create. For example, one can use controls as Dr. Warwick himself had done in the FRC Test.

Table 3
Percentages of Participants Who Though Ingredients Were Contained in Aspercreme and Mobisyl

Unaided Recall Mentions of Ingredients In Each Product:*

	Aspercreme Commercial Viewers:	Mobisyl Commercial Viewers:
Aspirin	17%	1%
Salycin	4	0
All other ingreds.	2	5
"No aspirin"	5	0
"None"	4	8
Don't know	68	87
No answer	2	0
(Number of Participants)	(130)	(100)

*The unaided recall question was, "Now thinking about the Aspercreme commercial, as best you can recall, what ingredient or ingredients, if any did the commercial say Aspercreme contained?", followed by the probe, "Were there any other ingredients mentioned in the commercial for Aspercreme?" (CX 27-Z115)

Percentages of Respondents to Aided Recall Agreeing That Various Ingredients Were Contained in These Products:**

	Aspercreme Commercial Viewers:	Mobisyl Commercial Viewers:
Aspirin	38%	5%
Salycin	20	12
Hydrocortisone	32	34
Lanolin	23	22
Menthol	15	19
(Number of Participants)	(130)	(110)

**The aided recall question was, "I'm going to read you a list of ingredients. As I read each one, please tell me if the commercial indicated whether *that particular* ingredient is present in the product even if you mentioned it to me before." (CX 27-Z115) [42]

The results of the aided recall questions are consistent with the hypothesis that a yeasaying bias exists, because a relatively large percentage of participants indicated that the control ingredients of hydrocortisone, lanolin and menthol were ingredients in both Aspercreme and the control product, Mobisyl. Nonetheless, the unaided recall results indicate that a sizable percentage of participants did not perceive or remember the disclosure that Aspercreme does not contain aspirin and that a much larger percentage of participants associated aspirin than salycin with Aspercreme. Similarly, the aided recall results indicate that a much larger percentage of those who viewed CX 9 believed Aspercreme contains aspirin than do those who saw the Mobisyl commercial. In addition, despite the likelihood of yeasaying bias which appears to exist in the ASI Theater Test data, the overall results indicate that the net impression conveyed by CX 9 to at least one group of average listeners was that Aspercreme contains aspirin.

(6) What "aspirin" means to reasonable consumers.

In our above discussion, we found that most of Thompson's advertisements have implied representations that Aspercreme contains aspirin. As we noted to begin with, however, one argument Thompson put forward for the proposition that such representations are not deceptive is that consumers understand "aspirin" as a generic description for products that are pain relievers, not only products containing acetylsalicylic acid. Thompson's argument raises the question of whether ordinary or [43] average consumers would interpret the word "aspirin" to imply a specific ingredient or whether they only net impression they would receive would be that of a generic pain reliever, leaving only an unrepresentative subset of consumers to think of aspirin as a specific drug.

The ALJ's initial opinion did not specifically address this point, perhaps because Thompson did not raise it before him with any great degree of clarity (*See, e.g.,* RMF 121, RAB 5). Thompson's argument as we interpret it is that consumers consider "aspirin" to be a generic reference to analgesics, so that representations that Aspercreme contains aspirin do not refer to acetylsalicylic acid. To support the allegations in Paragraphs 10(a), 11(a), 16 and 17 of the complaint—which allege that Thompson falsely represented Aspercreme to contain aspirin—Thompson's argument suggests complaint counsel must show that the product does not contain an effective analgesic.[32]

The controlling question presented by this argument is what reasonable consumers understand "aspirin" to be. It is insufficent for these purposes to note simply that scientists and medical experts understand "aspirin" to mean acetylsalicylic acid, since average consumers might not understand "aspirin" as would a scientist or doctor.[33] The conflicting expert opinions [44] offered by the parties on this question, drawing on research designed for other purposes, provide little assistance.[34] [45]

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[32] Claims that Aspercreme or TEA/S are effective analgesics are not alleged in the complaint to be false, but to be unsubstantiated. Thus there is little direct evidence of falsity, and we would have difficulty concluding that Aspercreme or TEA/S have been proved ineffective.

There are, however, three reasons why we are willing to conclude that at least some consumers within the mainstream do not consider "aspirin" to be a generic reference to all types of pain reliever. In the first place, Thompson's own ads repeatedly distinguish between Aspercreme and aspirin. Indeed, several specifically state that Aspercreme does *not* contain aspirin, or that it contains salycin. Thus, the evidence from Thompson's own advertising indicates that asirin is not a generic reference to all analgesics. Second, for aid in interpreting the common meanings of a word we occasionally look to dictionary definitions. They are derived from the ordinary usage of words and, as such, are of some use to us as indication of how [46] reasonable consumers would understand these words.[35] In this case, we have

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[33] On the contrary, we note that scientific and popular understandings are known to vary on occasion. For example, an average person would consider a spider to be an insect. To an entomologist, however, spiders are an order (Araneida) of animals in the class of Arachnida, whereas insects are animals in an entirely separate class (Insecta) of the phylum of articulate invertebrates (Arthropoda).

[34] Complaint counsel's witness testified that the findings in CX 26 (whose methodology we discuss below, at note 90), indicated consumers refer to aspirin as a specific type of internal analgesic rather than as a generic term for OTC pain relievers (Cohen, Tr. 163). However, CX 26's findings do not allow conclusions of this type to be drawn. The objective of CX 26 was to "find out whether or not the name Aspercreme led consumers to the inference that this product contained aspirin as an ingredient" (CX 26–B). Its objective was not to find out what consumers meant by "aspirin" when they stated that "Aspercreme" suggested aspirin content. There clearly is nothing in CX 26 which would allow inferences about whether consumers consider "aspirin" to refer to one specific type of internal analgesic or to be a generic phrase for many types of pain relievers with different chemical formulations.

Thompson's witness cited to the Mentholatum focus groups as supporting the opinion that people use the term "aspirin" to refer to a variety of analgesics with different chemical formulations (Ross, Tr. 5972–76). However, the Mentholatum focus group results, while supporting his testimony, conflict with the results contained in the reports from the Schneider (CX 52) and Nicholas (CX 53) focus groups, which support complaint counsel's position because participants in them believed Aspercreme contained aspirin and distinguished between aspirin and other pain relievers. *See* discussion below, at note 82. In any event, focus groups are not a research tool whose methodology permits use of their results as the basis for drawing generalizable conclusions. *Id.*

Thompson's witness also cited to the answers participants in the FRC Test (CX 35/RX 520) gave to the study's Question 3 as evidence that consumers understand "aspirin' as a generic pain reliever (Ross, Tr. 5976–79). Question 3 asked "What is aspirin?" The most frequent responses characterized it as a pain reliever (55%), a pain killer (11%), or as something that relieves headaches (7%) or pain (4%). Relatively few participants (2%) described it by giving a particular chemical name (*e.g.*, salicylic acid) or otherwise characterized it as a chemical, substance, or compound (2%) (RX 520H-J). Thompson's witness argued from this that fewer than 8% of consumers associate the word "aspirin" with a specific ingredient (RX 520C-D; Ross, Tr. 5978). However, Question 3 was too ambiguously framed to permit drawing such conclusions from it. The fact that many participants first associated the word "aspirin" with pain relief does not necessarily mean that they thought of the drug as a generic reference to all pain relievers. any more than the fact that people might first describe a Buick as a "car" would necessarily mean that they think "Buick" is a generic reference to automobiles. Further probing would have been necessary to show whether or not consumers distinguish between aspirin and analgesics based on other chemical compounds. Indeed, the answers to Question 4 of the same study strongly suggest that persons who characterized aspirin as a pain reliever in response to Question 3 did not necessarily think of the word as a generic reference to analgesics. Question 4a asked participants if they knew the chemical name for aspirin. The relatively small number (14) who answered "yes" were asked by Question 4b what the name was. Several of the participants who correctly described aspirin's specific chemical name as acetylsalicylic acid were among those who had responded to Question 3 by saying aspirin was a pain reliever (RX 520L; RX 517A-D).

[35] Definitions are less reliable than survey research as an indicator of how consumers understand advertisements because they can only provide the meanings generally used for words, rather than the specific meanings of the words in a particular context. The usage of a word in an advertisement may, of course, communicate a meaning at variance with the word's dictionary definitions, such as when it is used as slang. ("You can drive this lovely,

(footnote cont'd)

examined two widely used dictionaries, both of which define "aspirin" either as acetylsalicylic acid or as aspirin tablets. Neither of the dictionaries defines it as a generic reference to pain killers.[36] In the third place, we note the extensive advertising contemporaneously with Aspercreme of analgesics whose active ingredient is something other than aspirin, *e.g.*, acetaminophen (CX 54–Z042 to Z047). If there ever was a time when the only analgesics being marketed had aspirin as [47] their active ingredient, so that reasonable consumers might only think of "aspirin" as synonymous with pain killer, that time appears to us to be long past.

We recognize that consumers today might not be aware that aspirin's proper chemical name is, in fact, "acetylsalicylic acid." Nor do we exclude the possibility that reasonable consumers interpret the word "aspirin" in more than one way, with some thinking of it as a generic pain killer in the manner suggested by Thompson. Indeed, some consumers probably both are unaware of aspirin's chemical name and think of it as a generic pain killer. What we conclude, however, is that those persons who viewed or read the Asprecreme commercials and interpreted them to mean the product contains "aspirin," and who further thought "aspirin" is a specific chemical, fall within the range of persons who would be average or ordinary members of the adult population and, as such, are reasonable consumers. We therefore conclude that one net impression conveyed by Thompson's commercials is that Aspercreme contains acetylated salicylate.

3. *Recent Development of Aspercreme—Paragraph 10(b)*

The ALJ found that Thompson has represented Aspercreme to be a recently discovered or developed drug product (IDF 126, ID 135–36). Thompson has not argued on appeal that this finding was in error. [48]

We agree with the ALJ that the claims were made, but view them as implied rather than express. The representation that Aspercreme is a new product is contained in the headlines of five print ads, CXs 6–8, 10–11. Four of those ads, CXs 6–7, 10–11, contain identical lan-

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late model car home for just two thousand five hundred bananas.") However, we will consider dictionary definitions to be indicators of a word's meaning unless other extrinsic evidence or our own examination of the advertisement gives us reason to think that the context of a word makes dictionary definitions inapposite. It appears that the word "aspirin" is being used in CXs 3 and 4 in an ordinary manner. Therefore, reference to definitions to learn how consumers might interpret the word appears appropriate.

[36] Webster's Third New International Dictionary 130 (1976) defines "aspirin" as follows:

> 1: a white crystalline compound $CH_3COOC_6H_4COOH$ of salicylic acid used esp. in tablet form as an antipyretic and analgesic like the salicylates but producing fewer undesirable effects—called also *acetylsalicylic acid* 2: a tablet of aspirin.

A Supplement to the Oxford English Dictionary, Volume I 135 (1972) describes "aspirin" in this manner:

> A white crystalline compound, acetylsalicylic acid, used esp. as an analgesic and antipyretic; with *an* and *pl.* a dose of this in tablet form. Also *attrib.*

guage: "At last! A remarkable breakthrough for arthritis pain: Aspercreme." The headline of the other ad, CX 8, states: "There's always been aspirin . . . Now there's Aspercreme." Both headlines create an implied representation that Aspercreme is a new product by use of phrases that suggest Aspercreme was not hitherto available for purchase. The logical inference is that it was unavailable for purchase because it did not exist. Because the language used in the headlines clearly conveys a message of newness, and because there are no other elements in the ads which might alter the net impression created by the headlines, we find that the implied claims were made. [49]

4. *Aspercreme Is More Effective Than Aspirin Tablets—Paragraph 12(c).*

The ALJ found all of the nationally distributed Aspercreme ads to represent that Aspercreme is more effective than aspirin tablets because it works faster than aspirin tablets, or works without aspirin's side effects such as upset stomachs, or both (IDF 133). Thompson has asserted on appeal that its advertisements contained no such comparative superiority claims (RAB 5, 33).

Our own review of the record leads us to agree with the ALJ that seven of the ads, CXs 1–4, 7–8, and 37, made superiority claims. However, we conclude that there is inadequate information on the record from which to determine whether the remaining ads cited by the ALJ, CXs 5–6, 10–11, and 21–22, would be understood by ordinary consumers to state that Aspercreme is more effective than aspirin tablets.

The seven ads that we find to make comparative efficacy claims do so expressly. They contain either or both of two different superiority claims: (1) Aspercreme provides faster relief than aspirin tablets; and (2) Aspercreme does not cause the side effects of aspirin tablets.

One ad, the print ad CX 8, makes both claims. The headline of CX 8 states that Aspercreme "Works faster, safer than aspirin—relieves pain in minutes." [50]

Three other ads, the TV ads CXs 1 and 3 and the print ad CX 37, claim that Aspercreme lacks the side effects of aspirin tablets. In CXs 1 and 3, an announcer tells viewers that Aspercreme has ". . . none of aspirin's possible side effects." In CX 37, the text of the ad states that Aspercreme "has a *non*-aspirin pain reliever, so it can't cause aspirin's stomach upset or any of aspirin's side effects."

In yet another three ads, the TV ads CXs 2 and 4 and the print ad CX 7, the claim is made that Aspercreme works more quickly than aspirin tablets. In CXs 2 and 4, it is made expressly by a combination of visual and audio elements. As an announcer states "When you take regular aspirin, it goes throughout your body like this." the visual portion of the ads show the outline of a man's body with a few rays streaming outward from the stomach. One of these rays is shown reaching the man's left shoulder. The announcer then continues, "But, in seconds, Aspercreme starts concentrating all the temporary relief of two aspirin directly at the point of minor arthritis pain" while the video portion of the ad shows a heavy concentration of rays streaming outward from a point on the left shoulder to the rest of the shoulder. Given the announcer's claim that the outlines compare the ability of Aspercreme and aspirin to provide relief, the fact that the visual images show Aspercreme providing more rays to the shoulder area than aspirin tablets at the same point of time makes an explicit message that Aspercreme provides relief to the area of arthritis pain more quickly than aspirin tablets. In the print ad, CX 7, the text states that Aspercreme [51] "is actually faster and more effective than aspirin in relieving minor arthritis pain." It also states that Aspercreme "works faster than aspirin because you rub it in right where you hurt."

The remaining ads, CXs 5–6, 9–11, and 21–22, contain no explicit comparisons between Aspercreme and aspirin. Instead, they only make statements about the attributes of Aspercreme itself, without contrasting these attributes and those of aspirin. The ads state that Aspercreme does not upset the stomach (CXs 9 and 21–22), or that it has "no side effects" (CXs 10-11), or both (CX 6). None of the ads expressly states that aspirin tablets do upset the stomach or that they have unspecified side effects.

It may be that some consumers think of aspirin in association with stomach upset and that, upon hearing in an ad that Aspercreme does *not* cause stomach upset or other side effects, they would connect the two thoughts and conclude that the ad implies that Aspercreme is superior to aspirin. However, it is equally plausible that consumers would not make this connection. A simple examination of the ads does not provide us with sufficient information to determine whether reasonable consumers come away from these ads with the impression complaint counsel suggest. Therefore, this is a situation where we require extrinsic evidence before we can conclude with confidence that the ads imply Aspercreme is superior to aspirin.

Having examined the record, we do not find sufficient probative evidence to support complaint counsel's position that the ads make superiority claims. The evidence cited in the [52] initial decision (IDFs 134–37) was the opinion of marketing experts to the effect that various Aspercreme ads state the product to be more effective than aspirin. Having looked at the testimony ourselves, however, we note that it was not in reference to CXs 5–6, 9–11, or 21–22. Rather, it referred to those Aspercreme ads that we already have found to make express superiority claims. Therefore, we conclude that the record is insufficient for us to find that CXs 5–6, 9–11, and 21–22 make an implied representation of greater efficacy for Aspercreme than aspirin.

5. *Thompson Had Substantiation for Its Claims That Aspercreme Is Effective—Paragraphs 10c, 14.*

The Commission requires that advertisements containing objective product claims be supported by a reasonable basis.[37] If the advertisements contain express representations regarding a particular level of support that the advertiser has for the product claim (*e.g.*, "tests prove") or when the ad implies to [53] reasonable consumers that the firm has a certain level of support, the Commission expects the firm to have that level of substantiation. If the ad does not expressly or impliedly refer to a particular level of substantiation, the Commission determines the adequacy of the advertiser's existing substantiation using a number of factors—such as the ease of obtaining substantiation or the cost of a false claim—identified in *Pfizer, Inc.*, 81 F.T.C. 23 (1972) and subsequent cases.[38]

The complaint in this matter charges Thompson both with representing that it had a particular level of substantiation for claims that Aspercreme is effective (Paragraph 10c) and with making objective product claims (the efficacy claims) that imply the existence of substantiation without representing a particular level for it (Paragraph 14). We conclude that Thompson did make both types of representation. In our discussion, we first will explain why we conclude that several Aspercreme ads represented the existence of a particular level of substantiation. Then we identify, for the remaining ads, the objective product claims implying the existence of a reasonable basis. [54]

The ALJ concluded that two Aspercreme ads, CXs 7–8, represent that valid studies have scientifically proven that Aspercreme is more effective than orally-ingested aspirin for the relief of minor pain of arthritis and rheumatic conditions (IDF 129). We agree with the ALJ concerning CXs 7–8, and further find that another print ad, CX 37, also represents that efficacy claims for Aspercreme have been scientifically proven. Moreover, we find the claims in all three ads to have been expressly made.

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[37] For example, in three other recent analgesics cases we have required that efficacy claims be supported by a reasonable basis. *See Bristol-Myers Co., supra* note 8; *Sterling Drug, Inc.*, 102 F.T.C. 395 (1983), *aff'd*, No. 83–7700 (9th Cir. August 28, 1984); *American Home Products Corp.*, 98 F.T.C. 136 (1981), *aff'd*, 695 F.2d 681 (3rd Cir. 1982). We discuss the operation of our reasonable basis requirement in more detail in Part IV of this decision. However, we note here that the rationale for it under a deception theory is that objective product claims carry with them an express or implied statement that the advertiser has some amount of support for the claim. Consumers find these representations of support to be important information in evaluating the reliability of the product claims. Therefore, injury is likely if the advertiser lacks support for the claims.

[38] *Pfizer* used an unfairness analysis to reach the conclusion that the failure to have a reasonable basis violates Section 5(a) of the FTC Act. We do not rely upon such an analysis here. Rather, we find Thompson's failure to have a reasonable basis is deceptive by using the analysis first used in *National Dynamics Corp.*, 82 F.T.C. 488 (1973), *aff'd and remanded on other grounds*, 492 F.2d 1333 (2d Cir.), *cert. denied*, 419 U.S. 993 (1974); *reissued*, 85 F.T.C. 391 (1976).

Two of the ads, CXs 7–8, use similar language. Both state that Aspercreme was "tested" by a leading arthritis specialist on his own patients, with the results indicating that Aspercreme is actually faster and better than aspirin. CX 8 additionally refers to the test as a "controlled clinical test." The references to tests by a medical specialist, or "clinical tests," are an express reference to the type of test acceptable to the medical scientific community. Because the ads contain these express claims, we find it reasonable for consumers to expect that the claims that Aspercreme is faster and more effective than aspirin would be substantiated in a manner acceptable to the [55] medical scientific community.[39] The third ad, CX 37, does not compare Aspercreme's effectiveness to that of aspirin, but does expressly claim that Aspercreme's active pain reliver "is clinically proven to give strong, effective relief at the point of arthritis pain." Therefore, we operate on a presumption, which may be rebutted by extrinsic evidence (but was not in this proceeding), that reasonable consumers would expect scientifically acceptable evidence to support the claim that Aspercreme provides effective relief.

Because the representations that scientific substantiation exists are express, we need not consider whether the product claims for which the substantiation supposedly exists are objectively verifiable ones. If an advertiser states that he has substantiation of a given sort for assertions about his product's characteristics, we presume reasonable consumers would believe the substantiation capable of having been acquired by the advertiser. [56]

Having identified three Aspercreme ads that expressly represent the existence of a particular level of substantiation, we next examine whether any additional advertisements contain implied representations that Thompson had a particular level of substantiation for its Aspercreme efficacy claims. We conclude that the record is insufficient for us to find that any do.

Most of the remaining Aspercreme advertisements contain no elements whatsoever that might give reasonable consumers a net impression about a particular level of substantiation. However, four of the ads, CXs 2–4 and 6, contain visual elements that might create in the minds of reasonable consumers a net impression that Thompson was claiming to have scientific or medical substantiation for Aspercreme's efficacy claims. These visual elements are models that some consumers might consider scientific looking (CXs 2 and 4) or line drawings of the human body that also might carry with them a scientific aura (CX 6).[40] Consumers might further draw from such elements, at least where used in drug advertising, the inference that Thompson had performed tests acceptable to the scientific and medical community. On the other hand, it might be that ordinary persons viewing the ads would think no further than that the models and drawings were visual aids to assist the announcer in making points. Because we are unable to interpret these visual elements [57] as implied claims of scientific support and in the absence of extrinsic evidence to assist us in understanding how consumers actually understand these ads, we cannot say whether or not one net impression the ads leave is of the fact that there is scientific support for the assertions that Aspercreme is an effective pain reliever.[41]

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[39] On appeal, Thompson has argued that Commission consideration of the fact that CXs 7 and 8 refer to a scientific test as the basis for efficacy claims should be influenced by the fact that "these two print advertisements were disseminated to such a limited extent as to have had virtually no impact in the marketplace" and because the claims were "not prominent" in the body copy of the advertisements (RRB 18). We reject both these contentions. In the first place, our inspection of the ads shows us that the claims Thompson characterizes as being "not prominent" were no more or less prominent than other claims in the body of CXs 7 and 8. In the second place, we reject as fundamentally erroneous the implicit suggestion that an advertiser may avoid responsibility for express representations by later claiming that the representations were not widely distributed. Such arguments may have some bearing on the extent of the relief ordered by the Commission. They have no bearing on the issue of liability for deceptive acts or practices.

Given our conclusion that only three Aspercreme ads expressly represent the existence of a particular level of substantiation, and given our further conclusion that the record does not demonstrate any other Aspercreme ads to make such a [58] representation impliedly, we finally must consider whether the efficacy claims in the remaining Aspercreme ads are objective product claims impliedly representing an unspecified level of substantiation, or whether they are "puffing" representations that do not.[42] The issue is not a difficult one to decide. The record in this proceeding contains ample evidence that efficacy claims for OTC pain relievers can be and are objectively verified (*See, e.g..*, CXs 268–69). Indeed, Thompson did not argue that its efficacy claims were puffery, but rather that it had adequate substantiation for them (RAB 9–23). We therefore conclude that all efficacy claims in the Aspercreme ads are objective product claims.[43]

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[40] These sorts of visual elements also are found in CXs 7–8 and 37, ads which we have already found to represent expressly through other elements contained in them that Thompson had scientific evidence to support its efficacy claims for Aspercreme.

[41] Our approach here is consistent with that we followed in our two other recent analgesics cases, *Bristol-Myers* and *Sterling Drug*, where we concluded that similar visual images were insufficient to show an implied claim of scientific proof. For example, we stated in *Bristol-Myers, supra* note 8, at 323:

> [I]n CX 61, 63 and 64, a computer typewriter prints out a column made up of the words "Bufferin" and "aspirin" on graph paper at the same time as the announcer speaks about scientific tests. * * * Although the computer typewriter enhances the implication [of scientific support created by phrases such as "scientific tests show"], . . . we do not think that it alone can create the impression of scientific support for the claim. Similarly, we do not think that glass models of people with Bufferin and aspirin tablets crumbling in their stomachs and reforming in their heads indicates that Bufferin's superior speed has been scientifically established.

The difference between our opinions here and in *Bristol-Myers*, one of emphasis, is due to a refinement in our analysis since we decided that case. There we concluded the visual elements did *not* convey an impression of scientific support. Here we merely say that complaint counsel failed to provide extrinsic evidence demonstrating that they created a net impression which did. We do not attempt to use our judgment to reach any substantive conclusion. Where the implied meanings of an advertisement are unclear absent extrinsic evidence, our expertise is no more reliable in permitting conclusions that an interpretation is unreasonable than that it is reasonable.

[42] "[T]here is a category of advertising themes, in the nature of puffing or other hyperbole, which do [*sic*] not amount to the type of affirm ative product claims for which either the Commission or the consumer would expect documentation." *Pfizer, supra* p. 53, at 64.

III. WERE THE CLAIMS MATERIAL?

After having determined which claims were made by Thompson's advertisements, we next turn to examine whether or not those claims were material. A "material" misrepresentation or practice is one that is likely to affect a consumer's choice of or conduct regarding a product. In other words, it is information that is important to consumers. **[59]**

The Commission considers certain categories of information presumptively material. First, the Commission presumes that express claims are material. Similarly, when evidence exists showing that a seller deliberately made an implied claim, the Commission presumes materiality. The underlying rationale in both instances is the assumption that the willingness of a business to promote its products reflects a belief that the consumers are interested in the advertising.

In this case, Thompson itself has acknowledged making claims about Aspercreme's basic efficacy in relieving the pain and other symptoms associated with minor pain of arthritis and rheumatism.[44] Because this acknowledgement clearly demonstrates Thompson's intent, we presume that all basic efficacy claims for Aspercreme, whether express or implied, are material. We also have found that several Aspercreme ads expressly represent Aspercreme to be more effective than aspirin tablets and that **[60]** another set of ads expressly represents Aspercreme's efficacy to have been proven by the results of scientific tests. Therefore, we presume these claims are material.[45]

However, the two remaining claims at issue in this proceeding are implied claims that Thompson has not acknowledged deliberately making. These are the claims that Aspercreme contains aspirin and that it is a new product. In assessing the materiality of such implied claims, we are required to make our own evaluation of whether or not reasonable consumers would consider the information in the claims important. One aid to us in doing so for many claims is the fact that over the years our cases have established several categories of claims pertaining to the central characteristics of a product or service, such as those relating to its purpose, safety, efficacy, or cost. We now presume that any implied claim in one of these categories is material. [61]

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[43] *See* our discussion of efficacy claims below, at pp. 78–85.

[44] By "basic efficacy claims," we refer to the claims listed in Paragraphs 12a–12c and 12e of the complaint.

[45] In considering the materiality of claims, we are mindful of the Supreme Court's observation in *F.T.C. v. Colgate-Palmolive Co.*, 380 U.S. 374, 392 (1965), that the Commission's inference of materiality must be "within the bounds of reason." Accordingly, we do not use our presumption as an inflexible rule that eliminates our need to look at materiality on a case-by-case basis. On the contrary, the presumption simply reflects our general judgment that substantive claims in advertisements (in other words, claims other than "puffery" or window-dressing) would not have been made except to affect a consumer's choice or conduct regarding a product. Thus, the very existence of the claim ordinarily is sufficient evidence for us to conclude it is material. However, respondent is always free to counter this evidence either with arguments pertaining to the content of the ad itself or with extrinsic evidence. Moreover, the presumption does not preclude us from exercising our own judgment and concluding from evidence in the advertisement (or extrinsic evidence) that a claim is not material even if the respondent does not dispute materiality.

However, neither the claim that Aspercreme contains aspirin nor the claim that it is a new product appears to fall into any of the above-mentioned categories of claims. Therefore, we must look at the facts on the record to determine whether or not reasonable consumers would consider the claims important.

The ALJ already has analyzed the materiality of the claim that Aspercreme contains aspirin (IDFs 162–64).[46] He found that consumer research in the record shows a significant portion of test subjects preferred an aspirin product over a non-aspirin product for pain relief (IDF 163). For example, in the Lieberman Study 53% of the arthritics tested expressed a preference for an aspirin product (RX 500F, Warwick, Tr. 5333–34).[47] The ALJ also found that Thompson's expert witnesses did not dispute the proposition that aspirin is a drug of choice for treatment of minor arthritic pain (IDF 162). Having reviewed the ALJ's findings, we agree with them and consider them a sufficient basis for concluding aspirin content claims to be material. [62]

The ALJ did not, however, explicitly discuss why claims that Aspercreme is a new product are material.[48] Accordingly, we must examine that issue ourselves.

We conclude that these newness claims are material because they imply product efficacy to arthritis sufferers. Rheumatoid arthritis and osteoarthritis are chronic diseases having no cure (O'Brien, Tr. 3946–47). Arthritis diseases cause suffering to their victims and cripple tremendous numbers of persons each year (CX 268, p. 35,455). As a result, arthritis sufferers are constantly looking for cures, with more money being spent on unproven arthritis remedies than on legitimate arthritis research (Roth, Tr. 1537). Testimony by arthritis specialists (Roth, Tr. 1540; Ehrlich, Tr. 4109–11) and medical literature cited in the record (*See, e.g.*, O'Brien, Tr. 3775–76) show that in this context, where no existing remedy is fully adequate, arthritis sufferers enthusiastically try new remedies in the hope that these remedies will provide relief beyond that they are obtaining from existing remedies.

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[46] The aspirin content claim is the only one whose materiality the ALJ discussed. Because a finding as to materiality is integral to a determination that a representation is deceptive, such findings should be made with respect to any claim upon which a respondent is found liable for deceptive advertising.

[47] By citing to a specific percentage figure (which happens to be over the fifty percent level), we do not mean to imply that any particular level of expressed preference must be reached before we would conclude a claim like this one to be material. A lower level than that found in this case clearly could also suffice, depending upon the circumstances surrounding the claim and the intensity of the preference expressed by consumers.

[48] We presume from the general tenor of the ALJ's discussion of this claim (IDFs 126–28, ID 135–36) that he did, in fact, believe newness claims to be material.

These facts warrant the conclusion that the Aspercreme ads representing the product as "new," CXs 6-8 and 10-11, also impliedly represent it as a product effective in providing relief of arthritis pain. Efficacy claims are one category of claims [63] that our previous cases have found to concern central product characteristics.[49] Therefore, efficacy claims are presumptively material.

Evidence from the ads themselves confirms our conclusion that Thompson was making implied efficacy representations when it represented Aspercreme to be a new product. Four of the ads, CXs 6-7 and 10-11, use the words "remarkable breakthrough" in describing the product. The headlines in the four ads state: "At last! A *remarkable breakthrough* for arthritis pain: Aspercreme" (emphasis added). A "breakthrough" is something new in the sense that it did not exist for more than a short time before. But it is more than that. A breakthrough is something resulting from a significant advance in scientific knowledge. Use of the word "remarkable" to modify the word "breakthrough" makes even stronger the implied message that the product is the result of a major scientific advance. The net impression left with reasonable consumers may be not merely that Aspercreme, like other products, is an effective arthritis remedy, but that it is a more effective arthritis remedy than the others. However, we find that the newness claims constituted, at a minimum, implied representations of basic efficacy. [64]

IV. WERE THE REPRESENTATIONS ONES LIKELY TO MISLEAD CONSUMERS ACTING REASONABLY?

1. *Factually Inaccurate Claims, Generally.*

To this point, our analysis has shown that Thompson made a variety of express and implied claims that were material to reasonable consumers. However, material claims are not deceptive if the messages they convey to reasonable consumers are accurate. Thus, to make a case that advertising is deceptive, the Commission has the burden of showing that the material claims communicated to reasonable consumers by the advertising are false in some manner.[50] In other words, deceptive representations must be "likely to mislead."[51]

There are two different analytic routes by which complaint counsel can prove advertisments are likely to mislead. One is to carry the burden of proving that the express or implied message conveyed by the ad is false. The other is to show that the advertiser lacked a reasonable basis for asserting that the [65] message was true.[52] For example, if an advertisement claims that a new brand of orange juice is more nutritious than others on the market, the Commission could put on its own evidence showing the claim to be false or it could show that the substantiation the advertiser had to support the ad did not provide a reasonable basis for the claim of greater nutritional value. Because the two forms of proof are different, we keep them analytically separate even where a complaint charges, as does this one, both that the advertiser made false claims and that it made claims lacking a reasonable basis.

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[49] *See, e.g., Bristol-Myers, supra* note 8, *Sterling Drug, supra* note 37, *J.B. Williams Co.*, 68 F.T.C. 461 (1965), *aff'd*, 381 F.2d 884 (6th Cir. 1967).

[50] *See, e.g., Bristol-Myers, supra*note 8, at 320: "If an ad conveys more than one meaning to reasonable consumers and one of those meanings is false, that ad may be condemned. *National Commission on Egg Nutrition v. F.T.C.*, 570 F.2d 157, 161 n.4 (7th Cir. 1977), *cert. denied*, 439 U.S. 821 (1978)."

[51] Not only representations are capable of being "likely to mislead." Commission precedent also treats as likely to mislead both practices conveying a material false impression and omissions of material information doing the same. This case involves neither such practices nor such omissions. Therefore, the discussion in the text refers solely to representations. However, the analysis applies equally to other forms of deceptive conduct.

In this case, Paragraph 11 alleges that three of the claims made by Thompson were "false, misleading, or deceptive." In other words, the complaint signals that complaint counsel must carry the burden of proving the claims to be false. These three claims are: (1) that Aspercreme contains aspirin (Paragraph 10a); (2) that it is a recently discovered or developed drug product (Paragraph 10b); and (3) that valid studies have scientifically proven it to be more effective than aspirin tablets for the relief of the symptoms of arthritis and rheumatic conditions (Paragraph 10c). We therefore are required to determine whether the evidence put on by the Commission shows the claims to be false. [66]

For the claim that Aspercreme contains aspirin, our above discussion has already demonstrated falsity. The active ingredient in "aspirin" is acetylated salicylate, whereas the active ingredient in Aspercreme is TEA/S. The two are not the same. Therefore, the claim that Aspercreme contains aspirin is false.

The second allegedly false claim is that Aspercreme is a recently discovered or developed drug product. The ALJ's disposition of this issue was not explicitly listed by Thompson as a ruling on which the ALJ erred (RAB 5). However, the company did argue on appeal that most consumers generally had no knowledge of TEA/S products prior to 1979, when Aspercreme national advertising commenced, because Aspercreme itself had only been marketed in Ohio and two other OTC drug products containing TEA/S were: (1) more expensive; and (2) sold mainly through physician recommendation (RAB 3). We infer from this that Thompson believes it was legitimate for CXs 6-8 and 10-11 to claim that Aspercreme was a "new" drug product.

The ALJ found that Thompson had made the representations alleged in Paragraph 10b (IDFs 126–28, ID 135), but was persuaded that such claims were not likely to mislead because they were made "during the period when Aspercreme was being nationally advertised for the first time" (ID 136). Despite finding that Thompson's newness claims were not deceptive when made, the ALJ nonetheless included in his proposed order a ban on making any [67] further such claims, stating, "In any event, Thompson should not make new drug claims for Aspercreme in the future" (ID 136). We disagree with the ALJ's analysis, though not with his result.

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[52] This method of proof is only available to the Commission for objective product claims. For such claims, the representation "X is true" carries with it the implied representation that "The claim 'X is true' is supported by a reasonable basis." The Commission proves that the advertising is likely to mislead by proving that it is *not* supported by a reasonable basis. This does not preclude the possibility that the claim "X is true" is correct, although the possibility typically is an unlikely one.

As we described above, Thompson's advertising described Aspercreme as a recently discovered or developed drug product, thus representing that the product itself or its drug ingredient was new. In contrast, paragraph 11b of the complaint alleges:

> Aspercreme is not a recently discovered or developed drug product; it has been available for purchase since at least 1971 and its active ingredient has been in existence since at least 1954.

Thompson's arguments and the ALJ's decision both appear to focus only on the "new product" aspects of the complaint allegations in discussing the propriety of the company's claims. The record shows that Aspercreme was not marketed nationally prior to 1979 and that it had only limited availability between 1971 and 1979. In light of this evidence, we cannot conclude that the "new product" claims for Aspercreme are false as alleged.

However, we believe that an order provision prohibiting "new drug" claims is appropriate on the basis of a different paragraph, Paragraph 12. Paragraph 12 states that Thompson made express and implied efficacy representations for Aspercreme. As our discussion in Part III of this opinion shows, the newness claims for Aspercreme also were implied efficacy claims. All [68] Thompson's efficacy claims are deceptive for failure to have a reasonable basis.[53] Therefore, we conclude that an order provision barring the newness/efficacy claims is warranted.

The third claim the complaint alleges to be false is the claim that Thompson possessed a particular level of substantiation for its efficacy claims, that level being scientific tests. This claim was made in three of the Aspercreme ads (CXs 7–8 and 37).[54] To prove these claims false, complaint counsel had to establish the standards a test must meet to pass muster in the view of the medical community as support for the types of claims Thompson was making, and then show that Thompson's tests did not meet these standards. This burden was met.

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[53] Our discussion below, at pp. 81–83, explains why we conclude that Thompson lacked a reasonable basis for its efficacy claims.

[54] *See* our discussion above at pp. 54–55.

Both our discussion below and the ALJ's findings (IDFs 214–42) reach the conclusion that the standard generally adhered to by the medical scientific community for testing the efficacy of a drug is the possession of two well-controlled clinical tests. The ALJ's careful and methodical examination of every test introduced into the record by Thompson (IDFs 246–333) establishes that the tests fall short of this standard. It follows that Thompson's claims to possess one or more tests acceptable to the scientific community were false. [69]

2. *Claims Lacking a Reasonable Basis.*

In addition to charging that Thompson made false claims the complaint alleges (in Paragraph 13) that Thompson lacked a reasonable basis for the objective product claims listed in Paragraph 12. These are the various claims that Aspercreme is an effective drug for the relief of arthritis pain.[55] Thompson's admissions or our own findings have established that the company did, in fact, make such claims. Now we must determine what level of substantiation Thompson should have had for them and consider if Thompson did possess such substantiation for the advertisements in question.[56][70]

Starting with *Pfizer*,[57] and *National Dynamics*,[58] our reasonable basis cases have identified several factors that we will weigh in determining the appropriate level of substantiation for objective advertising claims. We recently summarized the factors, as developed by our prior cases, in a policy statement on advertising substantiation. That policy statement is attached to this opinion as an appendix. The factors it summarizes include: (1) the product involved; (2) the type of claim; (3) the benefits of a truthful claim; (4) the ease of developing substantiation for the claim; (5) the consequences of a false claim; and (6) the amount of substantiation experts in the field would agree is reasonable.[59][71]

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[55] Paragraph 12 itself identifies three different sorts of efficacy claims found in Thompson's ads: (1) claims that Aspercreme is an effective drug; (2) claims that Aspercreme is as effective a drug as aspirin tablets; and (3) claims that Aspercreme is a more effective drug than aspirin tablets. As a legal matter, it might have been possible for Thompson to possess a reasonable basis for only one or two of the three claims, but not for all of them. For example, Thompson might have tests showing that TEA/S is effective, but not tests comparing TEA/S's efficacy to that of aspirin tablets. In this case, however, none of the evidence offered by Thompson was adequate to support any one of the three types of efficacy claims identified in the complaint. Our discussion therefore does not distinguish among them.

[56] The advertisements in question are CXs 1–6, 9–11, and 21–22. We already have found three other Aspercreme ads, CXs 7–8 and 37, to have expressly represented the existence of scientific proof for Aspercreme efficacy claims. Accordingly, the efficacy claims in those ads would have to be supported by scientific proof regardless of whether or not our analysis here concluded such substantiation was necessary for the remaining Aspercreme ads.

[57] *Supra*, p. 53.

[58] *Supra*, note 38.

[59] This case is similar to three other recent Commission cases involving OTC analgesics, *American Home Products*, *supra* note 37, *Sterling Drug*, *supra* note 37, and *Bristol-Myers*, *supra* note 8. Those cases speak of "establishment claims" for OTC analgesics and state that if a claim is an "establishment claim," it must be substantiated by two well-controlled clinical tests. We do not use the term "establishment claim" here. However, our analysis is consistent with that we employed earlier. "Establishment claims" are claims that the efficacy of a drug has been scientifically proved, *i.e.*, "established." In our three recent cases, we stated that we require such

(footnote cont'd)

Applying those factors here leads us to conclude that Thompson should possess two well-controlled clinical tests to have a reasonable basis for its Aspercreme efficacy claims. The first criterion we consider is the type of product. In this [72] case, the product is a drug whose application is supposed to improve the physical welfare of its users by reducing pain and the other symptoms of minor arthritis. In past cases involving health or safety issues, we have required a relatively high level of substantiation, typically scientific tests.[60]

The second factor we consider is the type of claim. Our past cases have identified at least two types of claims that require a high level of substantiation, such as scientific or engineering tests. One is a claim that refers to specific facts or figures, rather than making generalized descriptions of the product's capabilities.[61] The other is a claim whose truth or falsity would be difficult or impossible for consumers to evaluate by themselves.[62] This case involves the latter, [73]

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claims to be substantiated by evidence sufficient to satisfy the relevant scientific community of the claim's truth. We further stated that the appropriate level of substantiation for other claims would be determined by considering factors such as the harm to consumers if the claim were false. (These are the factors developed in *Pfizer* and subsequent cases.) *See, e.g., Bristol-Myers, supra* note 8, at 321.

Our analysis here does not employ the term "establishment claim" to avoid creating the impression that claims for an advertiser's possession of scientific proof will be treated by us as a unique category of claims. There is no conceptual or practical reason to single out such claims for special treatment. They are but one example of an express or implied claim that an advertiser possesses a particular level of substantiation. Other such claims might include claims that a particular flower's ability to grow in hot, dry weather had been field-tested (we might require that such claims be substantiated by field tests conducted according to recognized horticultural standards) or that surveys show consumers prefer one brand of orange juice to another (we might require that such claims be backed by appropriate survey research).

Considered from a rigorously analytical perspective, none of these claims actually falls within the advertising substantiation principles set forth in *Pfizer* and subsequent cases. *Pfizer* holds that the Commission itself may identify the appropriate level of substantiation for ads that do not expressly or impliedly claim a particular level of substantiation. It also lays out the factors we will consider in setting the appropriate level of substantiation. We do not have to perform such an evaluation where an advertisement itself makes express or implied substantiation claims. We treat such claims like any other representations contained in the ad. We verify that it is reasonable to interpret the ad as making them, that the claims are material, and that they are false. If so, they are deceptive under Section 5(a) of the FTC Act.

Such an analytic approach is easier for us to employ than if we have to evaluate a case using the *Pfizer* factors. However, the end result in either event, assuming we find liability, is an order requiring the advertiser henceforth to have substantiation for the objective product claims being made. From the perspective of the final result, therefore, all cases ending up in a substantiation order can be considered ad substantiation cases.

This case involves both ads expressly claiming a particular level of substantiation and those to which we must apply the factors outlined in *Pfizer*. The express substantiation claims are those in CXs 7–8 and 37, ads representing that scientific tests prove Aspercreme to work faster and more effectively than aspirin tablets. We discussed those claims at pp. 58–60, above. However, the remaining Aspercreme advertisements did not make express or implied claims to a particular level of substantiation. Therefore, in this section of the opinion we employ the *Pfizer* factors to identify the proper level of substantiation for those advertisements.

[60] *See, e.g., Firestone Tire & Rubber Co.*, 81 F.T.C. 398, 475 (1972), *aff'd*, 481 F. 2d 246 (6th Cir.), *cert. denied*, 414 U.S. 1112 (1973) (safety and performance claims for automobile tires must be substantiated by "competent scientific tests"); *National Commission on Egg Nutrition*, 88 F.T.C. 89, 192 (1976), *aff'd*, 570 F.2d 157 (7th Cir.), *cert. denied*, 439 U.S. 821, *reissued*, 92 F.T.C. 848 (1978) ("Parties making claims about the attributes of products—and particularly about the safety of products—owe to the public a high degree of precision and care."); *Porter & Dietsch, Inc.*, 90 F.T.C. 770, 885 (1977), *aff'd*, 605 F. 2d 294 (7th Cir. 1979), *cert. denied*, 445 U.S. 950 (1980) (claims that any food, drug, or device can help a user achieve any result, such as weight loss, must be substantiated by "competent scientific or medical tests or studies").

[61] *See, e.g., National Dynamics Corp., supra* note 38 (valid laboratory tests would provide reasonable basis for claims concerning specific attributes of battery additive, such as claims for "quick starts in −40 degrees" or "increases brightness of lights by 25%").

[62] *Bristol-Myers, supra* note 8; *Sterling Drug, supra* note 37; *American Home Products, supra* note 37.

not the former type of claim.[63] As the ALJ's opinion explains in some detail (IDFs 196–206), arthritis pain is a phenomenon that is not constant. The pain ebbs and flows, making it hard for individual consumers to assess for themselves whether the relief they feel at a given moment is due to a particular treatment they are taking or is a natural phenomenon. This difficulty would be compounded for a new product such as Aspercreme by the "placebo effect," a phenomenon whereby patients' hopes and expectations cause them to believe, often for extended periods of time, that a clinically ineffective medication is providing them with real relief.[64] (The same placebo effect is also capable of influencing doctors' judgments about drugs they are testing or [74] prescribing if they know a drug's identity.) Thus, efficacy claims for Aspercreme are precisely the sort that consumers would not be able to verify easily for themselves.[65]

We often consider the third and fourth *Pfizer* factors in conjunction with each other. The third factor is the benefit of a truthful claim. The fourth factor is the ease of developing substantiation for the claim. Our concern in analyzing these factors is to ensure that the level of substantiation we require is not likely to prevent consumers from being told potentially valuable information about product characteristics. In this case, the benefit to consumers from the advertising messages in dispute would be significant if Aspercreme provided both faster relief and relief with fewer side effects than aspirin tablets. However, the record in this case does not suggest that requiring two well-controlled clinical tests as substantiation of efficacy claims for this product (or similar analgesics) would significantly reduce the likelihood of consumers being told about effective remedies for the relief of arthritis pain. The market for such remedies is large, being in excess of 18 million persons [75] in the United States alone.[66] The

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[63] Some Aspercreme ads refer to the product as providing relief in "seconds." It could be argued that these ads refer to specific figures for the speed with which the product acts. On balance, however, we do not find these references to be the sort of specific figures (*e.g.*, "provides 50 amps starting power at zero degrees Farenheit") referred to in the cases holding advertisers who make such claims to a higher level of substantiation than otherwise.

[64] Two additional factors noted by the ALJ also would make it difficult for consumers to evaluate the efficacy of Aspercreme in a nonclinical setting. Many consumers use other medications as well as Aspercreme. This would make it hard for them to separate out which product is the source of the relief they feel (IDF 198). Furthermore, the method of applying Aspercreme is by rubbing. Rubbing itself is known to have a soothing effect upon musculoskeletal pain (IDF 199). The relief generated by rubbing might be attributed to a nonexistent medical effect of the product being rubbed, masking the product's ineffectiveness.

[65] The fact that consumers and doctors in uncontrolled environments cannot readily evaluate the efficacy of Aspercreme is a principal reason why we reject Thompson's claims that efficacy of the product can be substantiated by evidence such as the clinical observations of doctors or marketing data (RAB 20).

[66] The report of the FDA Panel on OTC Internal Analgesics (CX 268, p. 35,455) provides the following statistics:

Incidence of rheumatic disease [arthritis] in the United States during 1974

Rheumatic disease	Number of persons (millions)
Osteoarthritis	12
Rheumatoid arthritis	5
Gout	1

(footnote cont'd)

potential sales for such a remedy are correspondingly large, as is evidenced by the fact that Thompson's 1981 sales of Aspercreme approached $6 million (IDF 74). By comparison, the cost of a well-controlled clinical trial of an analgesic's efficacy would be between $10,000 and $15,000 (Adriani, Tr. 1176–77, Roth, Tr. 1562). This means the total cost of complying with the reasonable basis requirement we establish for Aspercreme would not exceed approximately $30,000. In view of the large potential market and likely high demand for analgesics suitable for treating arthritis symptoms, these costs should not deter the development or advertising of new arthritis remedies.

The fourth factor we consider is the consequences of a false claim. In this connection, the ALJ's opinion stated that use of an ineffective drug (*i.e.,* one not significantly different from a placebo) to treat arthritis would be both injurious to health (IDFs 207–09) and economically harmful to consumers (IDF 210). Having reviewed the evidence, we agree with the ALJ's finding that the failure to treat arthritis with effective remedies can [76] cause significant economic harm to the consumer. Those costs result from the repeated purchase of an ineffective product by consumers who are unable to evaluate drug efficacy in an easy manner. However, we differ with the ALJ's findings regarding the health effects of Aspercreme.

The ALJ notes (IDF's 208–09) that failure to diagnose and treat rheumatic diseases with effective medication can seriously harm an individual's health. Where an OTC product is represented or used as a long-term treatment or cure for arthritis, there is a potential for substantial consumer injury because OTC products do not prevent the progression of the two principal forms of arthritis—osteoarthritis and rheumatoid arthritis.[67] Where an OTC product is advertised or used for the temporary relief of minor arthritis pain, in contrast, there is little potential for the product to cause serious injury to consumers' health if [77] claims about its effectiveness in relieving pain prove false. In this case, we find that the health risk from using Aspercreme as represented to relieve minor arthritis pain is uncertain and should

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Systemic lupus erythematosus	0.4 to 0.5
Juvenile rheumatoid arthritis	0.25

[67] Our conclusions about potential physical harm to consumers rest in large part upon the characterizations of arthritis provided by the monograph of the FDA's Panel on OTC Internal Analgesics (CX 268). The panel notes that each of the two principal forms of arthritis—osteoarthritis and rheumatoid arthritis—has a different cause, a different prognosis, and a different method of treatment. (CX 268, p. 35453) Active treatment of osteoarthritis requires physical measures and surgical management to retard progression of the disease. As the panel report notes, "[n]o medication has been shown to retard the development or progression of degenerative joint disease. (Citation omitted.) Pharmacologic agents [drugs] play a relatively minor role in the management of osteoarthritis." (CX 268, p. 35456) Aspirin is the mainstay of therapy for rheumatoid arthritis, but is must be administered in dosages much higher than those listed on labels of OTC products sold for the relief of pain in order to obtain the anti-inflammatory effects that retard progression of the disease. OTC drugs, including Aspercreme, do not prevent the progression of these common forms of arthritis, and their continued use as self-medication could result in serious health consequences to consumers.

be minimal if the product is used according to the warning on the label that a physician should be consulted if pain persists beyond a short period of time.

The sixth factor we consider is the amount of substantiation experts in the field would consider reasonable. As has been made clear in our past decisions[68] and by the ALJ's initial decision in this matter (IDFs 214–22), the substantiation standard generally applied by the scientific and medical community to claims for the efficacy of an analgesic is that they must be based on the results of at least two well-controlled clinical trials. Evidence from the record of this matter showing that this is the general standard includes the fact that regulations issued by the Food and Drug Administration[69] apply such a standard to all OTC drugs and the fact that the standard was applied to analgesics, in particular, by the panels of independent experts who evaluated OTC internal analgesics and external analgesics (including TEA/S) for the FDA (CXs 268 and 269). [78]

The FDA regulations recognize the possibility of exceptions to this general rule.[70] In fact, the panels reviewing OTC external and internal analgesics each approved a few OTC drugs without requiring two clinical tests, as Thompson has pointed out (RAB 14–15). However, the existence of these exceptions is not inconsistent with a general rule in the medical community requiring two well-controlled tests to show efficacy, any more than would be the existence of a minority body of opinion holding to some other standard.[71]

In this case, we have not only evidence of the standards generally applied by the medical community to efficacy claims for OTC drug products, but specific evidence that impartial experts do not believe TEA/S's efficacy to have been demonstrated [79] according to appropriate standards. The "active" ingredient of Aspercreme was reviewed by the Panel on OTC External Analgesics in 1979. It held that the efficacy of TEA/S had not been established (CX 269, p. 69,856). After the panel's report was submitted to the FDA, agency personnel independently evaluated the panel's findings. During FDA's evaluation period, interested persons were entitled to submit additional evidence supporting the efficacy of ingredients that the panel had found not to be proven effective. Accordingly, Thompson submitted to the FDA the studies it asserts in this proceeding to be well-controlled clinical tests. The results of FDA's deliberative process and its evaluation of Thompson's evidence are found in the "tentative final monograph" on OTC external analgesics, which was published for public comment in 1983. The tentative final monograph reiterates the panel's conclusion that TEA/S has not been proven effective and dismisses each of Thompson's proffered "clinical tests" as inadequate (CX 443, p. 5,855).[72] Although the tentative final monograph is subject to public comment and possible revision before the FDA publishes a final monograph, the tentative final monograph reflects the agency's considered judgment and current position on the merits.

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[68] *See, e.g., Bristol-Myers, supra* note 8, at 338, 376–77.

[69] 21 C.F.R. 314.111(a), 330.10(a)(4)(ii) (1983).

[70] *See, e.g.,* 21 C.F.R. 330.10(a)(4)(ii):

> . . . Proof of effectiveness shall consist of controlled clinical investigations as defined in §314.111(a)(5)(ii) of the chapter, unless this requirement is waived on the basis of a showing that it is not reasonably applicable to the drug or essential to the validity of the investigation and that an alternative method of investigation is adequate to substantiate effectiveness. Investigations may be corroborated by partially controlled or uncontrolled studies, documented clinical studies by qualified experts, and reports of significant human experience during marketing. Isolated case reports, random experience, and reports lacking the details which permit scientific evaluation will not be considered. General recognition of effectiveness shall ordinarily be based upon published studies which may be corroborated by unpublished studies and other data.

[71] We do not believe it necessary in deciding this case to attempt to identify all the situations when exceptions from the general rule will be permitted. The positions of the Panel on OTC External Analgesics and of the FDA on TEA/S demonstrate that an exception is not appropriate for this particular chemical substance.

Therefore, based upon our review of the six *Pfizer* factors, we conclude that the proper level of substantiation for Aspercreme efficacy claims is two well-controlled clinical [80] tests. We are additionally persuaded to use this level of substantiation because our above discussion indicates that this is the standard currently being required of TEA/S by the Food and Drug Administration. We believe that advertisers of drug products subject to the joint jurisdiction of the FTC and the FDA will benefit from greater regulatory certainty if they can act with reasonable assurance that the two agencies will accept the same evidence to demonstrate the safety and efficacy of a particular ingredient. Thus, we state that advertisers who comply with the FDA's requirement of well-controlled clinical tests to demonstrate efficacy have adequate substantiation to make such claims in their advertisements. Although we do not preclude ourselves from also permitting advertisers to use other types of evidence to comply with our substantiation requirement, nothing in this record suggests any rationale for our permitting a different form of substantiation for efficacy claims in Aspercreme advertisements than the FDA is prepared to establish for the product's labeling.[73] On the contrary, the inability of consumers to evaluate analgesic effect by themselves in an uncontrolled environment is a persuasive reason for consumers to expect (and us to require) appropriate scientific testing before efficacy claims are made. [81]

In reaching our conclusion that Thompson lacked a reasonable basis for its Aspercreme efficacy claims, we reject Thompson's arguments to the contrary. The first argument, relying on the testimony at trial of Thompson's expert witnesses, is that the scientific and medical community does not consider just one type of evidence (*i.e.*, well-controlled clinical tests) sufficient to demonstrate drug efficacy (RAB 13). While the argument would be true enough if it were merely an assertion of the point hitherto acknowledged by us, that the medical community may on occasion permit an exception to the general rule of well-controlled clinical tests, this is not what Thompson would have us find. Rather, the company wishes us to accept the proposition that the medical community does not, as a general matter, require well-controlled clinical tests to support claims of drug efficacy. We find this assertion contrary to the preponderance of the evidence in the record of this case and, accordingly, reject it.

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[72] The FDA's position contradicts Thompson's assertion (RAB 17) that "... three double-blind clinical studies supported efficacy [of Aspercreme]."

[73] Consistent with this view, our order would permit Thompson to advertise Aspercreme as an effective analgesic "... if the Food and Drug Administration promulgates any final standard that establishes conditions under which such product is safe and effective under the Food, Drug, and Cosmetic Act," whether or not the standard requires two well-controlled clinicals. (We have no reason to think FDA would dispense with the requirement of two well-controlled clinicals.)

Thompson next asserts that not even the FDA requires the existence of two adequate and well-controlled studies as the basis for an OTC drug efficacy claim (RAB 14–16), relying principally on the fact that FDA panels reviewing various OTC drugs have not invariably required such evidence. As we stated earlier, however, the existence of exceptions does not, in and of itself, disprove the existence of the general rule. For example, the three external analgesics approved by the FDA Panel on External Analgesics without two well-controlled clinical tests came from a group of over forty drugs reviewed by that panel (CX [82] 269, p. 69,790). Moreover, complaint counsel have presented us with persuasive explanations of why these particular exceptions were made.[74]

Third, Thompson argues that it did have three double-blind clinical studies on Aspercreme, studies that met the applicable standards of the FDA and the medical community (RAB 17–18). We find it remarkable that Thompson would make this assertion in light of the FDA's present position that Thompson's studies are [83] inadequate (CX 443, p. 5,855). Moreover, we are independently persuaded by the evidence on our own record (discussed in IDFs 246–312) that each of Thompson's tests had one or more serious flaws that prevents it from complying with the standards for a well-controlled clinical test.

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[74] Complaint counsel's answering brief states (CAB 14):

> Two of the drugs Thompson points to are counter-irritants, which are a specific class of drugs that exert their analgesic action in a unique way, by producing the sensation of warmth or coolness on the skin. Accordingly, since these drugs' mechanism of action is understood, clinical trials of various counterirritants would be adequate to document the efficacy of counterirritants as a class. (Roth, Tr. 1763–64). Moreover, in the case of all three of these external analgesics, the External Analgesic Panel specifically states that there are reports about each in the published literature and cites to authoritative compendia on drugs. In contrast, TEA/S is an obscure drug, and is not listed in any of these compendia. (F. 345). [IDF 345]

Also explanatory of the exceptions are the comments of the Panel on OTC External Analgesics itself. For example, in discussing turpentine oil, one of the two counterirritants it found effective, the panel stated:

> Due to the ingredient's wide use and clinical acceptance and on the basis of published reports in the literature, the Panel concludes that turpentine oil is effective for use as an OTC external analgesic.
>
> No scientifically controlled studies concerning the use of turpentine oil alone for the treatment of rheumatism, arthritis, and muscular aches and pains were found. However, the use of turpentine oil for self-medication is almost an American folk tradition, and full-strength turpentine oil has been employed with impunity as a topical counterirritant. (CX 269, p. 69,840)

Finally, Thompson argues that its possession of a reasonable basis for its Aspercreme ads is underscored by the quality of the individuals who came forward to testify on its behalf (RAB 20–21). Unfortunately for Thompson, however, none of the factors established by *Pfizer* or our other reasonable basis cases suggests that the credentials of a respondent's witnesses should be a substitute for factual evidence as a basis for objective product claims. Moreover, the testimony of experts, no matter how well-qualified they may be, is no substitute for controlled clinical testing as a means of substantiating the drug efficacy claims at issue in this case.

In addition to the above arguments, Thompson asserts that it is inappropriate for the Commission to take action against Aspercreme before the FDA reaches a final decision on whether or not TEA/S has been proven effective (RAB 28–31).[75] In other [84] words, Thompson suggests that it is inappropriate for the Commission to reach a final decision on whether or not TEA/S has been proven effective when the issue is still an open question at the Food and Drug Administration. Thompson further implies that evidence it submitted to the FDA too late for that agency to review prior to publication of the tentative final monograph on OTC external analgesics will persuade the FDA to conclude that TEA/S has been proven effective when it publishes the final monograph on OTC external analgesics.

It is true that the FDA's proceeding is still open and that the agency could reverse its tentative decision on TEA/S. However, we have no reason to believe this will happen. As the ALJ's initial decision points out (IDFs 387–99), the new material submitted by Thompson to the FDA does not appear to contain two (or even one) well-controlled clinical tests. Therefore, if the FDA continues to apply the standards it heretofore has applied to TEA/S, it should not find the new materials any more persuasive than the old.

In any event, our decision to issue an order in this proceeding does not rely upon a guess as to how the Food and Drug Administration ultimately will come out on the question of TEA/S's efficacy. Rather, it is based upon Thompson's failure to provide us with evidence that we think provided a reasonable basis for Aspercreme's efficacy claims. Moreover, the order we issue contains language allowing Thompson to rely for substantiation of Aspercreme efficacy claims upon any evidence conforming to a final standard for efficacy promulgated by the [85] FDA. Thus, if the FDA changes its position the result amounts to an automatic modification of our order.[76]

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[75] This is a favorable reading of Thompson's argument. As written, Thompson's brief merely asserts the ALJ to have "erred in holding that the External Analgesics Panel and the FDA have found TEA/S to be ineffective as a topical analgesic ingredient." However, nothing the ALJ stated in the initial decision suggests that he believed the FDA to have made a final determination. He correctly characterized the position expressed in the FDA's tentative final monograph for external analgesics (CX 443) as the FDA's "current position" (IDF 395). He stated his further belief that it is "highly unlikely" the FDA will reverse its position (IDF 400). He never expressly or impliedly stated that the FDA had finally determined TEA/S to be ineffective.

Indeed, we see very good reason for us to take action on Aspercreme despite the pendency of the FDA's OTC external analgesics review. FDA's proceeding is a rulemaking that must focus simultaneously on many different drugs, one of which is TEA/S. As Thompson itself has noted (RAB 30), while the date set for close of comments on the FDA's external analgesics tentative final monograph was April 9, 1984, it is uncertain how much additional time FDA will need before resolving all of the issues presented to it by the rulemaking. In contrast, the proceeding before us is an adjudicative one focused specifically on Aspercreme. Perhaps for this reason, we are in a position to reach our final determination before the FDA is able to reach its final determination. Given our conclusion that the Aspercreme advertising in evidence on our record is deceptive for failure to have a reasonable basis (among other reasons), it is in the public interest for us to act expeditiously to prevent further harm from the continuation of such advertising. [86]

V. SCOPE OF RELIEF

This part of the opinion discusses the order we enter against Thompson to prohibit and prevent it from engaging in deceptive acts or practices. Our order differs in several respects from the one proposed by the ALJ. Accordingly, we first discuss the rationale for each of our changes. We then discuss why we believe it appropriate for the order to apply not only to Aspercreme, but also to other drug products marketed by Thompson. Finally, we explain why we decided not to adopt an order provision that was urged upon us by complaint counsel, one that would have required Thompson to excise the "Aspercreme" brand name.

Our first change removes from the first paragraph of Parts I and II the word "labeling." The effect of this deletion is to limit application of the order to the "advertising, offering for sale, sale or distribution" of drug products. Our revision is intended to ensure that the order cannot be interpreted as applicable to any information the Food and Drug Administration either permits or requires Thompson to place on the labels of its drug products. For example, if the FDA permits Thompson to characterize Aspercreme as an analgesic during the pendency of the FDA's OTC drug review process, our order would not bar such labeling. On the other hand, any advertising placed on the label (*i.e.,* language not covered by FDA regulations) would be covered [87] by the order. The order as revised by us is identical with the orders in our three other recent analgesics cases, *American Home Products, Bristol-Myers,* and *Sterling Drug* in this respect.

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[76] We have included this language in our order because of our aforementioned view that it is advisable for us and the FDA to take a unified regulatory approach to issues brought before us where the issues appear identical or quite similar.

The ALJ apparently added the word "labeling" to Parts I and II to address a concern of complaint counsel. They felt the disclosure mandated by Part I.A (stating Aspercreme does not contain aspirin) had to be made both in Thompson's advertising and on the product label to be effective and that, therefore, the order had to apply to labeling (CPF 487). We agree with complaint counsel's belief that the disclosure needs to be on the product label to be effective. However, Part I.A of our revised order still requires that Aspercreme labels contain the desired disclosure *if* Thompson wishes to continue using the "Aspercreme" brand name in advertising or sales or otherwise to represent in ads that the product contains aspirin. Thus, the net effect of our revision is to make continued advertising and sale of a product named "Aspercreme" conditional upon a disclosure on its label that it does not contain aspirin, but not to make the order applicable to any labeling regulated by the FDA.

Our second change in the ALJ's proposed order broadens coverage of its Part I from "over-the-counter analgesic drugs" to "over-the-counter drugs" generally. We have broadened Part I's coverage because we agree with complaint counsels' argument on appeal that the facts of this case warrant such "fencing-in" to prevent deceptive acts or practices by Thompson in the future. We discuss in more detail below our reasons for reaching this conclusion. [88]

Our third change modifies the language of Part I.A by replacing the last "or" in it with the words "*provided, however,*" and by making other conforming changes. We made this technical revision because the langugage approved by the ALJ could literally be read as permitting Thompson to represent expressly (or impliedly) that Aspercreme contains aspirin as long as Thompson's advertising and labeling contained a disclosure that it does not. Our revision makes clear that Thompson may engage in no such conduct (other than use of the brand name "Aspercreme") regardless of whether or not it uses the disclosures required by the order.

Our fourth change is a revision to Part I.A.1 of the order. That provision sets out the requirements for disclosures that Aspercreme does not contain aspirin when the disclosures are used in television advertisements. As approved by the ALJ, it not only specified that the advertisements include both a clear and prominent vocal statement at the end of each ad informing consumers that Aspercreme does not contain aspirin and a clear and prominent video super advising consumers of the same fact, but also specified that the super must be displayed throughout the length of each advertisement. The requirement that the super be perpetually displayed throughout an entire ad strikes us as overkill. We have not imposed a similar requirement in any of our past affirmative disclosure cases and do not believe it is appropriate to do so here. Instead, we have revised Part I.A.1 to require that the visual super be displayed at the end of the ad simultaneously with the vocal disclaimer. [89]

Our fifth change from the ALJ's proposed order revises the language of Part I.B., the provision prohibiting false newness claims. We have made several changes in this provision. First, we have deleted the reference to new "mechanical" principles. Nothing in this case suggests Thompson has claimed (or plausibly could claim) that the efficacy of an OTC drug is based upon new mechanical principles. Second, we have deleted the prohibition on generally representing that a product is new (as opposed to representing that it involves new scientific principles) because the materiality of newness claims in general has not been established by the evidence before us. Third, we have deleted the language excepting from operation of the provision claims of newness made during a product's introductory period. We see no reason why Thompson, or any other advertiser, should be entitled to use the excuse of a "new" product (*e.g.,* an aspirin tablet marketed under a new brand name) to represent directly or indirectly for any period of time that the product is the result of a new scientific principle (*e.g.,* a new active ingredient) when it is not. Finally, to clarify the operation of Part I.B we have replaced the phrase "generally available for purchase" with the phrase "available for purchase as an over-the-counter drug." [90]

Our sixth change replaces a part of the order deleted by the ALJ, one that prohibits Thompson from misrepresenting the active ingredient(s) in any OTC drug products. The ALJ's initial decision does not explain why he omitted this provision, which had been included in the notice order accompanying the complaint. Whatever his rationale, we agree with complaint counsels' argument on appeal that the deletion was incorrect. Part I.D. of our order, the provision deleted by the ALJ, is based on one of the basic deceptive practices this case has shown Thompson willing to engage in—the misrepresentation of active ingredient. It prohibits such misrepresentations for any OTC drug products. Although Part I.A of the order prohibits the specific misrepresentation involved in this proceeding, misrepresentation of aspirin content, we believe Part I.D is necessary as fencing-in for the same reasons that prompt us to broaden the coverage of Part I from OTC analgesic drugs to OTC drugs generally. We discuss these reasons below.

Our seventh change is to Part II.A of the order. That part prohibits

Thompson from representing any OTC analgesic drug to be effective for the relief of symptoms of musculoskeletal disorders, unless Thompson has a reasonable basis for such claims, *i.e.*, two well-controlled clinical tests. Our revision removes a "delayed" effective date (April 9, 1984) that no longer would be in the future, given the passage of time since the ALJ issued his initial decision. An alternative would have been to extend the delay until such time as the FDA makes its final determination about TEA/S's efficacy. Unlike the ALJ, however, we question the [91] wisdom of such a course. Thompson already has had ample time during the pendency of this litigation to conduct the sort of tests that could establish efficacy to our satisfaction. If it has not done so, either out of conviction that it is not required to or out of fear that such tests would show Aspercreme to be no better than a placebo,[77] it will have to stop making efficacy claims in its advertising and offering for sale of Aspercreme until those tests are performed. While the inability to advertise that Aspercreme is effective will make it difficult (although not absolutely impossible) to market Aspercreme for a period of time, Thompson can always resume a full-scale selling campaign if and when it obtains the evidence of efficacy that it should have had all along.

Our eighth and final change is to add back to the order Parts IV and V, standard provisions for all our orders. Part IV requires Thompson to notify us prior to any proposed change in the corporation. Part V requires the company to file a compliance report within 60 days after service of the order upon it. These provisions appear to have been inadvertently omitted from the ALJ's proposed order. [92]

The order we adopt contains fencing-in provisions, *i.e.*, it would place restrictions on Thompson's ability to market products other than Aspercreme. Part II of the order requires a reasonable basis consisting of two well-controlled clinical tests if efficacy claims are made not just for Aspercreme, but for any OTC analgesic drug. Part I applies not only to analgesics, but also to any other OTC drug products Thompson might sell. We believe such fencing-in provisions are warranted in this case.

The ability of the Commission to issue orders containing fencing-in requirements is clear. *See, e.g., FTC v. Ruberoid Co.*, 343 U.S. 470, 473 (1952); *FTC v. Colgate-Palmolive Co.*, 380 U.S. 374, 394–95 (1965). The Commission has wide latitude in fashioning orders to prevent inventive respondents from pursuing a course of conduct similar to that found to have been unfair or deceptive in the past. However, the Commission's discretion is subject to two constraints. One is that the order must be sufficiently clear and precise to be understood by the violator. *See, e.g., Colgate-Palmolive,* 380 U.S. at 392. The second is that the order must bear a reasonable relationship to the unlawful practice found to exist. *See, e.g., Jacob Siegal Co. v. FTC,* 327 U.S. 608, 612–13 (1946).

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[77] Such a fear might well be warranted. As the ALJ's opinion notes (IDFs 376–89) five studies in evidence in this proceeding find no statistically significant difference between TEA/S and a placebo. The ALJ concluded that these studies, like Thompson's, were not well-controlled (IDF 374). However, the relative quality of these studies versus those relied on by Thompson is suggested by the fact that the FDA's Tentative Final Monograph on OTC External Analgesic Products cited to the findings of four of these studies as evidence that TEA/S has not been proven effective, and did so without critical comment, while criticizing the methodology of Thompson's three supposed clinical tests (CX 443, p. 5,855).

To ensure that a multi-product fencing-in order such as this one bears a reasonable relationship to the unlawful practice found to exist, the Commission considers three factors. They are: (1) the deliberateness and seriousness of the present violation; (2) the respondent's past history of violations; and (3) the transferability of the unlawful practices to other [93] products. The more egregious the facts with respect to a particular element, the less important it is that another negative factor be present. *See, e.g., American Home Products Corp. v. FTC,* 695 F.2d 681, 706 (3d Cir. 1982); *Sears Roebuck & Co. v. FTC,* 676 F. 2d 385, 392 (9th Cir. 1982). In considering these three factors, we find that two of them, the deliberateness and seriousness of the present violation and the transferability of the unlawful practices to other products, warrant adoption of the order we enter today.[78]

We look first at Thompson's present violations of the law. We have concluded that they are deliberate and serious. The seriousness of Thompson's violations is evidenced by the size and duration of Thompson's deceptive advertising campaign. As our above discussion shows, Thompson has been making deceptive efficacy and aspirin content claims since it began advertising Aspercreme in 1977. These claims have been made in numerous different ads on TV and in print in a campaign backed up by a multi-million dollar advertising budget (IDF 74). Such a persistent, long-term pattern of deceptive advertising evinces a [94] "massive, long-standing effort"[79] to persuade consumers that Aspercreme contains aspirin and that there is a reasonable basis for claiming it is effective.

The ads claiming that Aspercreme is a new breakthrough and that its efficacy is supported by scientific tests were run only in print ads, rather than in the TV commercials that commanded the bulk of Aspercreme's budget (RX 573). Even so, these ads were not insignificant. For example, the CX 6 print ad ran twice in the *Reader's Digest* and once in the *Saturday Evening Post* in 1979 (CX 25A). Print ads in such magazines of nationwide distribution would result in the objectionable representations being seen by large numbers of persons.

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[78] Complaint counsel argued on appeal that Thompson's history of past violations also provides grounds for a fencing-in order. However, the history cited by complaint counsel consists of a single consent order against Thompson issued in the early 1960s, *Thompson Medical Company, Inc.*, 59 F.T.C. 287 (1961) (CAP 17–18). Because consent orders do not constitute a legal admission of wrongdoing, we will not use a single consent order as a basis for concluding that Thompson has a history of past violations. We express no opinion on whether or not a pattern of consent orders would be a sufficient history of past violations to warrant fencing-in.

[79] *See American Home Products Corp.* v. *FTC, supra* note 37, 695 F. 2d at 707.

The seriousness of the violations also is affected by the fact that consumers could not readily judge the truth or falsity of the claims Thompson was making.[80] As our discussion above has noted, consumers cannot readily determine on their own whether or not an analgesic is effective. It would be even harder for them to determine whether or not a product advertised as a new "breakthrough" actually is one or to figure out whether supposed scientific tests showing that a product is faster and safer than aspirin would pass muster according to the general standards of the scientific community. Therefore, the claims Thompson emphasized in its advertising were ones to which consumers were particularly susceptible. **[95]**

Just as troubling as the seriousness of Thompson's violations is their apparent deliberateness. Deliberateness is shown by the consistency of Thompson's advertising themes over the years, supporting a conclusion that they were no accident or "isolated instance." *See, e.g., Jay Norris Inc. v. FTC*, 598 F.2d 1244, 1250 (2d Cir.), *cert. denied*, 444 U.S. 980 (1979).

Thompson has attempted to rebut the notion that it engaged in a deliberate campaign of deception by claiming that it did everything possible to ensure it had a reasonable basis for its Aspercreme efficacy claims.[81] We do not find it so easy to exonerate Thompson's conduct. Thompson excuses itself by asserting that it relied on the opinions of scientists it hired **[96]** as consultants, who advised it that Aspercreme was effective. Thompson seeks to avoid the charge that it should have realized those scientists were not relying on well-controlled clinical tests by arguing that it does not conduct in-house clinical investigations and lacks the expertise to evaluate such studies itself (RAB 9).

However, the facts on the record in this proceeding show a pattern of outside sources repeatedly warning Thompson that the efficacy of TEA/S had not been established. The FDA's Panel on OTC External Analgesics expressed this view in 1979. In early 1980, the National

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[80] *Id.*

[81] *See, e.g.*, Respondent's Answering Brief, at 7:

> The record shows that the state of mind of Thompson, from the time it first purchased the product Aspercreme (and even before), was directed towards satisfying itself, and accumulating ample scientific proof, that Aspercreme was both safe and effective for the temporary relief of minor musculoskeletal pain, including that minor pain associated with arthritis and rheumatism. Towards this goal, Thompson accumulated, at great expense, extensive medical and scientific opinions, reports and clinical documentation from numerous outstanding, well recognized authorities and experts. . . .

Thompson also argues that its money-back guarantee evidences its good faith reliance on the evidence that Aspercreme is effective. *Id.* at 10. However, a money-back guarantee is not a defense to a charge of deceptive advertising. *See, e.g., Montgomery Ward & Co. v. FTC*, 379 F.2d 666, 672 (7th Cir. 1967). In this case, the placebo effect would result in some consumers purchasing the product many times before discontinuing its use and/or asking for a refund on the last bottle bought. Therefore, a money-back guarantee would not eliminate substantial sales revenues even in the unlikely event that all consumers eventually invoked it.

Association of Broadcasters and each of the television networks advised Thompson that the documentation for Aspercreme's efficacy claims was inadequate and that the tests Thompson relied on were flawed. (*See, e.g.,* CXs 88, 89, 90–91). Also in and around 1980, Thompson became aware of four studies—Roth (CX 344Z–195), Ehrlich (CX 344Z–157), Charles (CX 344Z–168), and Brown (CX 344Z–182)—showing no statistical difference between TEA/S and placebos. In 1981, the director of the FDA's Division of OTC Drug Evaluation told Thompson that TEA/S had not been shown effective. His comments are particularly significant because he reviewed the clinical studies Thompson had submitted to the FDA after publication of the OTC external analgesics panel's report, the same studies Thompson has submitted to us. He wrote to Thompson that these studies were all deficient to prove Aspercreme's efficacy (CX 342; *see also* CX 343). Again in 1983, with the adoption of its tentative final monograph (CX 443), the FDA concluded that TEA/S has not been [97] proven effective. Through all of this, Thompson steadfastly argues that the scientific experts it employed (*e.g.,* the persons who performed the defective studies) believed TEA/S to be effective, that its studies are valid, that its other evidence (such as a 1981 non-projectable survey of pharmacists by a magazine, a survey critiqued by the ALJ in IDFs 369–71) is adequate to support efficacy claims, and that it is acting in good faith when it continues to rely on this evidence. Our reading of the record is that Thompson has known or should have known for some time now that its efficacy claims for Aspercreme are unsubstantiated. We further conclude that Thompson has deliberately continued making efficacy claims despite this fact.

Likewise, it seems clear that Thompson deliberately sought to lead consumers into the belief that Aspercreme contains aspirin. Again, Thompson had good reason to know that one reasonable interpretation of the product's labeling and advertising was that it contains aspirin. The company was warned of this possibility by the results of two focus group studies that it had available to it as early as 1978—the Nicholas and [98] Schneider focus groups.[82] Consumer belief in aspirin content also clearly was indicated by the results of the Mapes & Ross copy test in 1979 (CX 50), which examined the earliest Aspercreme [99] TV ads (CXs 1 and 2).[83] The possibility of such a net impression was further communicated to Thompson by the television networks and NAB in 1979 and 1980 (*See, e.g.*, CXs 79, 80, 88D).

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[82] The Nicholas focus group study (CX 52) was conducted in 1973 with two groups of eleven women, all of whom suffered from arthritis or some form of muscular aches and pains and all of whom were users of either topical analgesic or aspirin. The Schneider focus group study (CX 53) was conducted in 1978 with three groups of respondents (two groups of females and one group of males), all of whom used some sort of internal tablets or external rubs for arthritis relief. Participants in both the Nicholas and Schneider focus group studies were recruited and asked to use Aspercreme for at least ten days prior to the focus group session.

Because focus group studies are conducted with very few respondents obtained through nonprobability samples, and because the interviews are conducted in an unstructured group format, it is difficult to draw generalizable conclusions from them. Indeed, it is not unusual to obtain conflicting results from focus groups. *See, e.g.,* discussion at note 34 above. (One explanation for such conflicting results is that the moderator's control over discussions can skew them toward a particular result. It might be, therefore that 90% of the participants in a given focus group (9 out of 10 people) thought of "aspirin" as a particular chemical, and in another only 10% (1 out of 10), while a survey would show 60% of the general population to hold that belief.) Accordingly, we do not expect Thompson to have treated these focus groups by themselves as a fully reliable indication of consumers' beliefs about aspirin

(footnote cont'd)

The fact that the ads created a net impression of aspirin content appears to have been no accident. The document "Aspercreme Brand Review," prepared for Thompson by Ogilvy & Mather in July, 1980 (CX 54), shows the purpose of Aspercreme advertising was to communicate that Aspercreme is aspirin in a rub.[84] Moreover, when the networks insisted on a revision of the early TV ads to reduce the incidence of mistaken beliefs, and Thompson accordingly approved ads with supers stating "contains no aspirin" and "relief without aspirin" (CXs 3 and 4), it appears that Thompson continued to use the audio phrase "relief of aspirin" in the revised ads hoping that the phrase would [100] offset the disclaimer.[85] Thompson also made no attempt to test whether or not the disclosures in CXs 3 and 4 were effective.[86] In addition, Thompson apparently continued to use CX 9 and related TV commercials (the ones with the disclosure "contains salycin, a strong non-aspirin pain reliever") after the completion in early 1981 of consumer research that it had sponsored and from which it should have realized that the ads communicated a message that Aspercreme contains aspirin.[87] All of this conduct is evidence that

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content in Aspercreme. However, the focus groups did provide Thompson with exploratory information about those beliefs. The results of both the Nicholas and the Schneider focus group studies were consistent in demonstrating that there was a high probability that participants, would believe Aspercreme contains aspirin. Indeed, the final reports of both studies contain quotes that emphasize an aspirin association. For example, the Nicholas report states that one participant said, "When I saw it and saw 'Asper,' I right away thought it had aspirin in it. . . " (CX 52-L) and the Schneider study states "in addition, others felt they were attracted by 'Asper/Aspercreme' because 'it has aspirin in it' or is 'full of aspirin.' " (CX 53-Z56) Thus, both the Nicholas and Schneider focus group studies indicate that even after using Aspercreme for at least ten days several of the focus group participants believed that Aspercreme contained aspirin. The consistency of this finding across both studies should have been a warning signal to Thompson that potential consumers might be confused about the ingredients of Aspercreme.

[83] As discussed above, at pp 20-22, results from the Mapes and Ross Test indicated that between 21 and 35 percent of persons viewing CXs 1 and 2 believed Aspercreme contained aspirin.

[84] *See, e.g.,* CX 54Z-005:

> *Creative Strategy*
>
> The creative objective is to convince arthritis sufferers - men and women over 50 - that Aspercreme is the arthritis medicine that puts all the relief of aspirin directly at the point of pain.
>
> The reason why is that Aspercreme contains the pain relieving ingredient of aspirin in a penetrating carrier so that it is taken quickly through the skin into painful joints and muscles.

[85] A 1980 conference report summarizing a meeting between Thompson and Ogilvy & Mather (CX 66) to discuss running various new ads states: "The client [Thompson] agreed [to TV ads with supers] and will pursue approval of the aspirin equivalency claim. In the meantime the agency [Ogilvy & Mather] will puruse the 'strong relief of aspirin' claim to offset the contains no aspirin super.")

[86] Thompson has suggested to us that "the networks accepted these supers because they were sufficient to clarify any possible ambiguity" (RAB 47). This is not the case. At least one network warned that the supers were ineffective. *See*CX-80 (letter from Director of Commerical Clearance for CBS to Thompson): "In the new tape, the super (relief without aspirin) accomplishes little and may only serve to confuse the issue. For that reason, we have decided not to accept the revision but to remain with the original for a period of two months, until January 15, 1980. By that time, we will hope for some better-defined message which can avoid the present difficulty."

[87] *See* discussion *supra*, at 35-39.

Thompson has known full well for some time that consumers misunderstood the identity of the principal ingredient in Aspercreme and has continued to advertise in a manner that creates more such misunderstanding.

In addition, the "adaptability or transferability" of Thompson's violations to other products convinces us that a fencing-in order is appropriate. The scope of the order in this [101] case is similar to those in *American Home Products, Bristol-Myers,* and *Sterling Drug.* Those were cases that also involved claims for analgesic products. Our comments in *American Home Products,* 98 F.T.C. at 405, are equally apposite here: "The effort to misrepresent the nature of . . . [an] ingredient is a technique that could easily be applied to advertising of OTC drug products other than [this one]." Likewise, claims that tests prove a product's superiority or claims that its active ingredient is a breakthrough could readily be employed for any non-prescription drug product. Accordingly, it is necessary that Part I of this order apply to all such OTC drug products.

Part II of the order is narrower in scope than Part I, being limited to OTC analgesic drugs. It is so limited because our factual findings go only so far as to conclude that two well-controlled clinical tests are necessary as a reasonable basis for analgesic efficacy claims. Conversely, however, this analysis makes clear that no lesser standard than two well-controlled clinical tests is appropriate as a general rule for any analgesic product, whether its active ingredient is TEA/S or something else. It also is clear there is nothing inherently unique about Aspercreme or TEA/S to prevent Thompson from transferring the practice of claiming efficacy without such proof to other OTC analgesics. Thus, a fencing-in provision is warranted.

Finally, we comment on one order provision that complaint counsel urged upon the ALJ as well as upon us and that both he and we have rejected. It is an order provision that would [102] require Thompson to excise the "Aspercreme" brand name. Complaint counsel have asserted that brand name excision is a remedy the Commission has employed in the past when a brand name was deceptive and when no less restrictive alternative would suffice to eliminate deception (CAP 23-26). Complaint counsel further argue that such is the case here.

We agree with complaint counsel that brand name excision is a remedy available to us for use in extreme circumstances.[88] We do not find, however, that complaint counsel have made a sufficient case to warrant employing the remedy here. To order brand name excision, we would have to be persuaded that a less severe remedy, such as affirmative disclosures, could not correct the misimpression that Aspercreme contains aspirin. Complaint counsel have argued that the evidence in this case leads to such a conclusion (CAP 34–38). However, we do not find that this evidence justifies brand name excision. The evidence consists in part of the testimony by complaint counsel's marketing expert. He stated that the brand name is the most salient part of a commercial to consumers and that, therefore, the misperceptions generated by the brand name "Aspercreme" cannot be overcome by any disclaimers included in ads (CAP 34–36). This line of reasoning appears to prove too much. It leads to the conclusion that the Commission must ban any brand name suggesting an [103] ingredient not contained in the product. As Thompson has pointed out, however, there are numerous products on the market whose names suggest an ingredient they do not contain.[89] While no evidence is before us showing whether or not consumers are confused by those names, we think it probable that a properly designed ad campaign for such products, or for Aspercreme, could convey to consumers the message that the product is similar to but not identical with the ingredient suggested by the brand name. In any event, we are not willing to discount this possibility based upon one expert's opinion.

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[88] *See, e.g., FTC v. Algoma Lumber Co.,* 291 U.S. 67 (1934); *Resort Car Systems, Inc. v. FTC,* 518 F.2d 962 (9th Cir.), *cert denied,* 423 U.S. 827 (1975); *Continental Wax Corp v. FTC,* 330 F.2d 475 (2nd Cir. 1964); *Bakers Franchise Corp v. FTC,* 302 F.2d 258 (3rd Cir. 1962); *Moro Cigar Co. v. FTC,* 107 F.2d 429 (4th Cir. 1939).

The other evidence cited by complaint counsel (CAP 36–38) consists of the surveys on the record showing Thompson's TV disclosures that Aspercreme does not contain aspirin were [104] ineffective.[90] Complaint counsel argue this shows disclosures cannot work. However, complaint counsel agree with the ALJ and with us that Thompson's disclosures were "woefully insufficient" (CAP 37). Evidence that a poorly designed disclosure is ineffective, an unsurprising result, does not prove the inability of a well-designed disclosure to communicate a message to consumers. [105]

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[89] *See* RAB 41:

> The marketplace abounds with products whose marks suggest but do not describe a character or quality of the goods, as for example Bacos (no bacon), Sugar Twin (no sugar), Egg Beater (no egg), Cremora (no cream), Silkience (no silk), Cottonelle (no cotton), Tuna Twist (no tuna), Chock Full O'Nuts (no nuts), Chicken of the Sea (no chicken), Apple Beer (no beer), and Rubbermaid (no rubber) (Ross, Tr. 6083–6085; Silver, Tr. 5662-5664). The common sense "message" inherent in these names is "similar to", *i.e.*, similar to bacon, similar to sugar, etc.

[90] We have discussed these surveys, CXs 27, 32 and 35, above. It is arguable that another survey sponsored by complaint counsel, the ASI Interlock Experiment (CX 26), provides information about whether the brand name Aspercreme inherently leads consumers to believe Aspercreme contains aspirin. However, we do not believe that the survey supports such a conclusion. The objective of CX 26 was "to find out whether or not the name Aspercreme led consumers to the inference that this product contained aspirin as an ingredient." (CX 26–B) The research design involved showing each respondent a single stimulus which included the name Aspercreme, Ben-Gay or Mobisyl as well as the phrase "for the temporary relief of minor arthritis pain" (CX 26–C). They were then asked, "What ingredient or ingredients are suggested by the name ______?" (CX 26–Z32). We find this question to be ambiguous given the nature of the objective of CX 26 because the wording is not equivalent to asking people whether they belive a topical analgesic for the temporary relief of minor arthritis pain contains aspirin. This ambiguity can be illustrated with the following example. If people were asked what ingredients were *suggested* by a cigarette with the name "Old Gold" the response "gold" would be expected from many. If they were instead asked what ingredients the product *contained*, we would expect that very few would reply "gold." The question in CX 26 is similarly flawed. Additionally, the ambiguity in CX 26 was probably heightened because respondents were not told that Aspercreme is a topical analgesic rather than one that is taken internally. Therefore CX 26 does not provide probative evidence regarding whether the brand name Aspercreme causes reasonable consumers to believe that aspirin is an ingredient in Aspercreme. In addition, nothing in CX 26 tests whether or not any incipient potential for misperception could be overcome by disclosures.

VI. CONCLUSION

For the reasons set forth above, we affirm the administrative law judge's finding of liability and modify his initial decision as described.

APPENDIX

FTC POLICY STATEMENT REGARDING ADVERTISING SUBSTANTIATION

Introduction

On March 11, 1983, the Commission published a notice requesting comments on its advertising substantiation program.[1] To facilitate analysis of the program, the notice posed a number of questions concerning the program's procedures, standards, benefits, and costs, and solicited suggestions for making the program more effective. Based on the public comments and the staff's review, the Commission has drawn certain conclusions about how the program is being implemented and how it might be refined to serve better the objective of maintaining a marketplace free of unfair and deceptive acts or practices. This statement articulates the Commission's policy with respect to advertising substantiation. [2]

The Reasonable Basis Requirement

First, we reaffirm our commitment to the underlying legal requirement of advertising substantiation—that advertisers and ad agencies have a reasonable basis for advertising claims before they are disseminated.

The Commission intends to continue vigorous enforcement of this existing legal requirement that advertisers substantiate express and implied claims, however conveyed, that make objective assertions about the item or service advertised. Objective claims for products or services represent explicitly or by implication that the advertiser has a reasonable basis supporting these claims. These representations of substantiation are material to consumers. That is, consumers would be less likely to rely on claims for products and services if they knew the advertiser did not have a reasonable basis for believing them to be true.[2] Therefore, a firm's failure to possess and rely [3] upon a reasonable basis for objective claims constitutes an unfair and deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act.

Standards for Prior Substantiation

Many ads contain express or implied statements regarding the amount of support the advertiser has for the product claim. When the substantiation claim is express (*e.g.*, "tests prove", "doctors recommend", and "studies show"), the Commission expects the firm to have at least the advertised level of substantiation. Of course, an ad may imply more substantiation than it expressly claims or may imply to consumers that the firm has a certain type of support; in such cases, the advertiser must possess the amount and type of substantiation the ad actually communicates to consumers.

Absent an express or implied reference to a certain level of support, and absent other evidence indicating what consumer expectations would be, the Commission assumes that consumers [4] expect a "reasonable basis" for claims. The Commission's determination of what constitutes a reasonable basis depends, as it does in an unfairness analysis, on a number of factors relevant to the benefits and costs of substantiating a particular claim. These factors include: the type of claim, the product, the consequences of a false claim, the benefits of a truthful claim, the cost of developing substantiation for the claim, and the amount of substantiation experts in the field believe is reasonable. Extrinsic evidence, such as expert testimony or consumer surveys, is useful to determine what level of substantiation consumers expect to support a particular product claim and the adequacy of evidence an advertiser possesses.

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[1] 48 FR 10471, March 11, 1983.

[2] Nor presumably would an advertiser have made such claims unless the advertiser thought they would be material to consumers.

One issue the Commission examined was substantiation for implied claims. Although firms are unlikely to possess substantiation for implied claims they do not believe the ad makes, they should generally be aware of reasonable interpretations and will be expected to have prior substantiation [5] for such claims. The Commission will take care to assure that it only challenges reasonable interpretations of advertising claims.[3]

Procedures for Obtaining Substantiation

In the past, the Commission has sought substantiation from firms in two different ways: through industry-wide "rounds" that involved publicized inquiries with identical or substantially similar demands to a number of firms within a targeted industry or to firms in different industries making the same type of claim; and on a case-by-case basis, by sending specific requests to individual companies under investigation. The Commission's review indicates that "rounds" have been costly to both the recipient and to the agency and have produced little or no law enforcement benefit over a case-by-case approach. [6]

The Commission's traditional investigatory procedures allow the staff to investigate a number of firms within an industry at the same time, to develop necessary expertise within the area of investigation, and to announce our activities publicly in circumstances where public notice or comment is desirable. The Commission intends to continue undertaking such law enforcement efforts when appropriate. However, since substantiation is principally a law enforcement tool and the Commission's concern in such investigations is with the substantiation in the *advertiser's* possession, there is little, if any, information that the public could contribute in such investigations. Therefore, the Commission anticipates that substantiation investigations will rarely be made public before they are completed.

Accordingly, the Commission has determined that in the future it will rely on nonpublic requests for substantiation directed to individual companies via an informal access letter or, if necessary, a formal civil investigative demand. The [7] Commission believes that tailored, firm-specific requests, whether directed to one firm or to several firms within the same industry, are a more efficient law enforcement technique. The Commission cannot presently foresee circumstances under which the past approach of industry-wide rounds would be appropriate in the ad substantiation area.

Relevance of Post-Claim Evidence in Substantiation Cases

The reasonable basis doctrine requires that firms have substantiation before disseminating a claim. The Commission has on occasion exercised its discretion, however, to consider supporting materials developed after dissemination.[4] The Commission has not previously identified in one document the circumstances in which it may, in its [8] discretion, consider post-claim evidence in substantiation cases.[5] Such guidance can serve to clarify the program's actual operation as well as focus consideration of post-claim evidence on cases in which it is appropriate.

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[3] Individual Commissioners have expressed differing views as to how claims should be interpreted so that advertisers are not held to outlandish or tenuous interpretations. Notwithstanding these variations in approach, the focus of all Commissioners on reasonable interpretations of claims is intended to ensure that advertisers are not required to substantiate claims that were not made.

[4] The Commission's evidentiary rule, 16 C.F.R. 3.40, has sometimes been interpreted as precluding introduction of post-claim substantiation. In fact, it does not. Section 3.40 only provides a sanction against the introduction of evidence that should have been produced in response to a subpoena, but was not.

The Commission emphasizes that as a matter of law, firms lacking a reasonable basis before an ad is disseminated violate Section 5 of the FTC Act and are subject to prosecution. The goal of the advertising substantiation requirement is to assure that advertising is truthful, however, and the truth or falsity of a claim is always relevant to the Commission's deliberations. Therefore, it is important that the agency retain [9] the discretion and flexibility to consider additional substantiating evidence, not as a substitute for an advertiser's prior substantiation, but rather in the following circumstances:

- When deciding, before issuance of a complaint, whether there is a public interest in proceeding against a firm;
- When assessing the adequacy of the substantiation an advertiser possessed before a claim was made; and
- When deciding the need for or appropriate scope of an order to enter against a firm that lacked a reasonable basis prior to disseminating an advertisement.

First, using post-claim evidence to evaluate the truth of a claim, or otherwise using such evidence in deciding whether there is a public interest in continuing an investigation or issuing a complaint, is appropriate policy. This does not mean that the Commission will postpone action while firms create post-claim substantiation to prove the truthfulness of claims, nor does it [10] mean that subsequent evidence of truthfulness absolves a firm of liability for failing to possess prior substantiation for a claim. The Commission focuses instead on whether existing evidence that claims are true should lead us in the exercise of our prosecutorial discretion to decline to initiate a law enforcement proceeding. If available post-claim evidence proves that the claim is true, issuing a complaint against a firm that may have violated the prior substantiation requirement is often inappropriate, particularly in light of competing demands on the Commission's resources.

Second, post-claim evidence may indicate that apparent deficiencies in the pre-claim substantiation materials have no practical significance. In evaluating the adequacy of prior substantiation, the Commission will consider only post-claim substantiation that sheds light on pre-existing substantiation. Thus, advertisers will not be allowed to create entirely new substantiation simply because their prior substantiation was inadequate. [11]

Finally, the Commission may use post-claim evidence in determining the need for or appropriate scope of an order to be entered against a firm that lacked a reasonable basis. Thus, when additional evidence offered for the first time at trial suggests that the claim is true, the Commission may frame a narrower order than if there had been no post-claim evidence.

The Commission remains committed to the prior substantiation requirement and further believes that these discretionary factors will provide necessary flexibility. The Commission will consider post-claim evidence only in the circumstances listed above. But, whether it will do so in any particular case remains within its discretion.

Self Regulation Groups and Government Agencies

The Commission traditionally has enjoyed a close working relationship with self-regulation groups and government agencies whose regulatory policies have some bearing on our law enforcment initiatives. The Commission will not necessarily [12] defer, however, to a finding by a self-regulation group. An imprimatur from a self-regulation group will not automatically shield a firm from Commission prosecution, and an unfavorable determination will not mean the Commission will automatically take issue, or find liability if it does. Rather the Commission will make its judgment independently, evaluating each case on its merits. We intend to continue our useful relationships with self-regulation groups and to rely on the expertise and findings of other government agencies in our proceedings to the greatest extent possible.

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[5] The distinction between pre-claim and post-claim evidence is only relevant when the charge is lack of substantiation. For other charges, such as falsity, when evidence was developed is irrelevant to its admissibility at trial.

By direction of the Commission.

FINAL ORDER

The matter has been heard by the Commission upon the appeal of counsel for respondent Thompson Medical Company, Inc. and complaint counsel and upon briefs and oral argument in support of and in opposition to the appeals. The Commission, for reasons stated in the accompanying Opinion, has granted a portion of complaint counsel's appeal and denied that of respondent. Therefore

It is ordered, That the initial decision of the administrative law judge be adopted as the Findings of Fact and Conclusions of Law of the Commission except as is otherwise inconsistent with the attached Opinion.

Other Findings of Fact and Conclusions of Law of the Commission are contained in the accompanying Opinion.

It is further ordered, That the following Order to Cease and Desist be entered:

ORDER

I

It is ordered, That respondent, Thompson Medical Company, Inc., a corporation, its successors and assigns, and respondent's officers, representatives, agents and employees, directly or through any corporation, subsidiary, division or other device, in connection with the labeling, advertising, offering for sale, [2] sale or distribution of any over-the-counter "drug" as that term is defined in the Federal Trade Commission Act, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

A. Employing the brand name "Aspercreme" for such products or otherwise representing directly or by implication that an active ingredient of such product is aspirin, unless such product contains aspirin in therapeutically significant quantities; *provided, however,* that the brand name "Aspercreme" may be used for such product if its advertising and labeling clearly and prominently disclose that the product does not contain aspirin.

(1) In television advertisements, an explicit and simple aspirin disclaimer statement (such as "ASPIRIN-FREE") shall be superimposed on the television screen simultaneously with a vocal aspirin disclaimer statement (such as "Aspercreme does not contain aspirin") at the end of each advertisement.

(2) In radio advertisements, an explicit aspirin disclaimer statement (such as "Aspercreme does not contain aspirin") shall be made at the end of each advertisement.

(3) In print advertisements, an explicit aspirin disclaimer statement (such as "ASPERCREME DOES NOT CONTAIN ASPIRIN") shall be displayed prominently and conspicuously in relation to each such advertisement as a whole.

(4) In labeling, an explicit aspirin disclaimer statement (such as "DOES NOT CONTAIN ASPIRIN") shall be prominently and conspicuously printed in the front package panel (or in the front of the container if no package is used).

B. Representing, directly or by implication, that such product involves a new scientific principle, when such product or one involving such principle has been available for purchase in the United States as an over-the-counter drug for more than one year. [3]

C. Misrepresenting the contents, validity, results, conclusions, or interpretations of any test or study.

D. Misrepresenting the identity of the active ingredient(s) in such product.

II

It is further ordered, That Thompson Medical Company, Inc., a corporation, its successors and assigns, and respondent's officers, representatives, agents, and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, offering for sale, sale or distribution of any OTC analgesic "drug," as that term is defined in the Federal Trade Commission Act, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

A. Representing that such product is effective for the relief of minor pain and other symptoms of any musculoskeletal disorder (such as arthritis, tendonitis, bursitis, or rheumatic disorders).

B. Representing that such product is as fast as or faster than, or is as effective as, or more effective than any other drug or device in the relief of minor pain and other symptoms of any musculoskeletal disorder (such as arthritis, tendonitis, bursitis, or rheumatic disorders);

unless at the time of the dissemination of any such representation, respondent possesses and relies upon a reasonable basis for such representation consisting of competent and reliable scientific or medical evidence. For analgesic drug products competent and reliable scientific or medical evidence shall include at least two adequate and well-controlled, double-blinded clinical studies which conform to acceptable designs and protocols and are conducted by different persons, independently of each other. Such persons shall be qualified by training and experience to conduct such studies. *Provided however,* with respect to any representation covered by this part other than claims of superior or comparative effectiveness or safety, if the Food and Drug Administration promulgates any final standard which establishes conditions under which such product is safe and effective under the Food, Drug and Cosmetic Act, then in lieu of the above, respondent may rely upon scientific evidence which fully conforms to such final standards as a reasonable basis for said representation. [4]

III

It is further ordered, That so much of the complaint as relates to Paragraph 12 (f) be, and the same hereby is, dismissed.

IV

It is further ordered, That respondent Thompson Medical Company, Inc. shall notify the Commission at least thirty (30) days prior to any proposed change in the corporation such as a dissolution, assignment or sale resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change in its corporation which may affect compliance obligations under this Order.

V

It is further ordered, That the respondent herein shall within sixty (60) days after service of this Order upon it and at such other times as the Commission may require, file with the Commission a written report setting forth in detail the manner and form in which it has complied or intends to comply with this Order.

IN THE MATTER OF

BIOPRACTIC GROUP, INC.

CONSENT ORDER, ETC., IN REGARD TO ALLEGED VIOLATIONS OF SEC. 5 AND 12 OF THE FEDERAL TRADE COMMISSION ACT

Docket C-3148. Complaint, Dec. 12, 1984—Decision, Dec. 12, 1984

This consent order requires a Riegelsville, Pa. corporation, among other things, to cease representing that any new drug or device provides relief from the inflammation and joint stiffness associated with arthritis and other musculoskeletal ailments, unless such claims are substantiated by competent and reliable evidence. The Order also bars the company from making unsubstantiated claims that any drug or device has been praised as an effective treatment for arthritis and similar ailments by doctors, medical centers and athletic teams; or that any such product has been reported to be an important breakthrough in pain management in newspaper and magazine articles or on TV or radio. The company is additionally required to maintain records substantiating product claims, and to provide all personnel involved in the preparation of advertising and promotional materials with a copy of the Order.

Appearances

For the Commission: *William Haynes* and *Nancy Warder*

For the respondent: *Pro se.*

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act, and by virtue of the authority vested in it by said Act, the Federal Trade Commission, having reason to believe that Biopractic Group, Inc. (Biopractic), a corporation, hereinafter sometimes referred to as respondent, has violated the provisions of said Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges in that respect as follows:

PARAGRAPH. 1. Respondent Biopractic is a corporation with its office and principal place of business located at 328 Easton Road, Riegelsville, Pennsylvania.

PAR. 2. Respondent is now and has been engaged in the manufacturing, advertising, offering for sale, sale and distribution of Therapeutic Mineral Ice. In connection with the manufacture and marketing of Therapeutic Mineral Ice, respondent is now and has been engaged in the dissemination, publication, and distribution of advertisements and promotional material for the purpose of promoting the sale of

Therapeutic Mineral Ice for human use. As advertised, Therapeutic Mineral Ice is a "drug" within the meaning of Section 12 of the Federal Trade Commission Act.

PAR. 3. Respondent causes Therapeutic Mineral Ice when sold to be transported from its place of business in various states to purchasers located in other states. Respondent maintains, and at all times mentioned herein has had, a substantial course of trade in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act.

PAR. 4. In the course and conduct of its business, and at all times mentioned herein, respondent has been and now is in substantial competition in or affecting commerce with corporations, firms, and individuals engaged in the manufacture or marketing of health care products.

PAR. 5. In the course and conduct of its business, respondent has disseminated and caused the dissemination of certain advertisements and promotional materials for Therapeutic Mineral Ice, such as the advertising material attached hereto as Exhibit A, through the United States mail and by various means in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act.

PAR. 6. Through the use of the advertisements and promotional materials referred to in Paragraph Five, and others not specifically set forth herein, respondent represented, and now represents, directly or by implication, that:

a. Therapeutic Mineral Ice has been praised as an effective treatment for arthritis and other musculoskeletal ailments by medical doctors, leading medical centers, professional athletic teams, and the United States and Russian Olympic track teams; and

b. Therapeutic Mineral Ice has been reported to be an important new breakthrough in pain management in news reports of the Associated Press and in news stories in the *National Enquirer, Globe,* and *Star.*

PAR. 7. In truth and in fact:

a. Therapeutic Mineral Ice has not been praised as an effective treatment for arthritis and other musculoskeletal ailments by medical doctors, leading medical centers, professional athletic teams, and the United States and Russian Olympic track teams; and

b. Therapeutic Mineral Ice has not been reported to be an important new breakthrough in pain management in news reports of the Associated Press and in news stories in the *National Enquirer, Globe* and *Star.*

Therefore, the representations set forth in Paragraph Six were and are false, deceptive, misleading, and unfair, and the advertisements and promotional materials referred to in Paragraph Five were and are misleading in material respects, and have constituted and now constitute false advertisements.

PAR. 8. Through the use of the advertisements and promotional materials referred to in Paragraph Five and others not specifically set forth herein, respondent represented, and now represents, directly or by implication, that:

a. Therapeutic Mineral Ice will provide relief from the inflammation and joint stiffness that characterizes arthritis and other musculoskeletal ailments; and

b. Therapeutic Mineral Ice stimulates the beta-endorphins present in the human body.

PAR. 9. Through the use of the advertisements and promotional materials referred to in Paragraph Five, respondent has represented and now represents directly or by implication that, at the time the representations set forth in Paragraph Eight were made, it possessed and relied upon a reasonable basis for those representations.

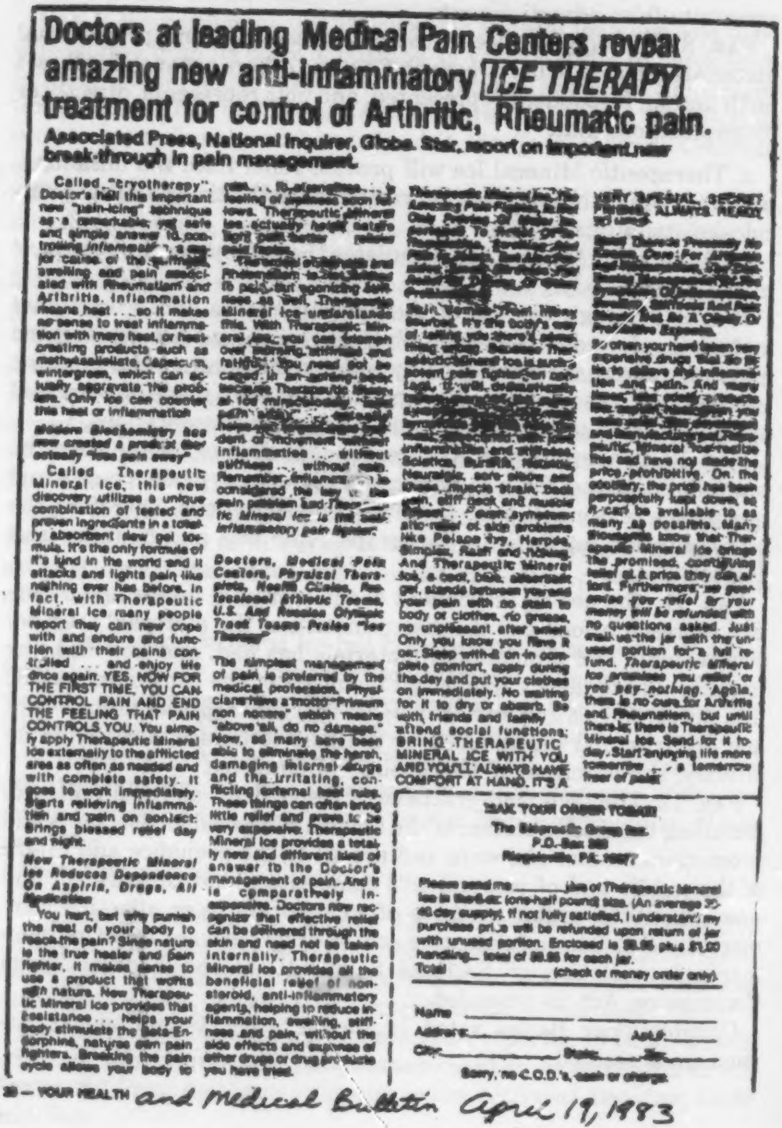
PAR. 10. In truth and in fact, respondent did not, at the time the representations set forth in Paragraph Eight were made, possess and rely upon a reasonable basis for those representations. Therefore, the representation set forth in Paragraph Nine was and is unfair and deceptive.

PAR. 11. The use by respondent of the aforesaid unfair and deceptive representations and the dissemination of the aforesaid false advertisements and promotional materials has had, and now has, the capacity and tendency to mislead members of the consuming public into the erroneous and mistaken belief that said representations were and are true and has induced, or is likely to induce, directly or indirectly, the purchase of Therapeutic Mineral Ice.

PAR. 12. The facts and practices of respondent, as herein alleged, including the dissemination of the aforesaid false advertisements and promotional materials, were and are all to the prejudice and injury of the public and of respondent's competitors and constituted, and now constitute, unfair methods of competition in or affecting commerce, and unfair and deceptive acts or practices in or affecting commerce in violation of Sections 5 and 12 of the Federal Trade Commission Act, as amended.

Commissioner Bailey voted in the negative. Commissioner Azcuenaga abstained.

EXHIBIT A



Doctors at leading Medical Pain Centers reveal amazing new anti-inflammatory ICE THERAPY treatment for control of Arthritic, Rheumatic pain.

Associated Press, National Inquirer, Globe, Star, report on important new break-through in pain management.

Called "cryotherapy", Doctor's hail this important new "pain-icing" technique as a remarkable, yet safe and simple answer to controlling *inflammation*, a major cause of the stiffness, swelling and pain associated with Rheumatism and Arthritis. Inflammation means heat . . . so it makes no sense to treat inflammation with more heat, or heat-creating products such as methylsalicylate, Capsicum, wintergreen, which can actually aggravate the problem. Only ice can counter this heat or inflammation.

Modern Biochemistry has now created a product that actually "ices pain away"

Called Therapeutic Mineral Ice, this new discovery utilizes a unique combination of tested and proven ingredients in a totally absorbent new gel formula. It's the only formula of it's kind in the world and it attacks and fights pain like nothing ever has before. In fact, with Therapeutic Mineral Ice many people report they can now cope with and endure and function with their pains controlled . . . and enjoy life once again. YES, NOW FOR THE FIRST TIME, YOU CAN CONTROL PAIN AND END THE FEELING THAT PAIN CONTROLS YOU. You simply apply Therapeutic Mineral Ice externally to the afflicted area as often as needed and with complete safety. It goes to work immediately. Starts relieving inflammation and pain on contact. Brings blessed relief day and night.

New Therapeutic Mineral Ice Reduces Dependence On Aspirin, Drugs, All Medication

You hurt, but why punish the rest of your body to reach the pain? Since nature is the true healer and pain fighter, it makes sense to use a product that works with nature. New Therapeutic Mineral Ice provides that assistance . . . helps your body stimulate the Beta-Endorphins, natures own pain fighters. Breaking the pain cycle allows your body to [illegible] . . . [illegible] . . . a feeling of [illegible] soon follows. Therapeutic Mineral Ice actually helps nature fight pain better [illegible]

[illegible] Rheumatism [illegible] to pain, but agonizing stiffness as well. Therapeutic Mineral Ice understands this. With Therapeutic Mineral Ice, you can triumph over [illegible] stiffness and fatigue. You need not be caged in [illegible] because Therapeutic Mineral Ice [illegible] freedom of movement without inflammation . . . without stiffness . . . without pain. Remember, inflammation is considered the key to the pain problem and Therapeutic Mineral Ice is the best anti-inflammatory pain fighter.

Doctors, Medical Pain Centers, Physical Therapists, Health Clinics, Professional Athletic Teams, U.S. And Russian Olympic Track Teams Praise "Ice Therapy"

The simplest management of pain is preferred by the medical profession. Physicians have a motto "Primum non nocere" which means "above all, do no damage." Now, as many have been able to eliminate the harsh, damaging internal drugs and the irritating, conflicting external heat rubs. These things can often bring little relief and prove to be very expensive. Therapeutic Mineral Ice provides a totally new and different kind of answer to the Doctor's management of pain. And it is comparatively inexpensive. Doctors now recognize that effective relief can be delivered through the skin and need not be taken internally. Therapeutic Mineral Ice provides all the beneficial relief of non-steroid, anti-inflammatory agents, helping to reduce inflammation, swelling, stiffness and pain, without the side effects and expense of other drugs or drug products you have tried.

Therapeutic Mineral Ice, The Amazing Pain Fighter, [illegible]

Pain [illegible] It's the body's way of telling you there's something wrong. Because Therapeutic Mineral Ice is such a potent pain fighter on contact, it will dramatically [illegible] inflammation and stiffness. Sciatica, Bursitis, Neuritis, Neuralgia, sore elbow and knees, muscle strain, back pain, stiff neck and muscle spasms . . . even symptomatic relief of skin problems like Poison Ivy, Herpes, Simplex, Rash and Itching. And Therapeutic Mineral Ice, a cool, blue, absorbent gel, stands between you and your pain with no stain to body or clothes, no grease, no unpleasant after smell. Only you know you have it on. Sleep with it on in complete comfort, apply during the day and put your clothes on immediately. No waiting for it to dry or absorb. Be with friends and family attend social functions: BRING THERAPEUTIC MINERAL ICE WITH YOU AND YOU'LL ALWAYS HAVE COMFORT AT HAND. IT'S A VERY SPECIAL, SECRET [illegible], ALWAYS READY TO USE.

[illegible] Care For Arthritis And Rheumatism [illegible] Of Inflammation [illegible] Of Prohibitive Expense.

So often you have taken very expensive drugs that do little to relieve the inflammation and pain. And [illegible] Therapeutic Mineral Ice realize this and have not made the price prohibitive. On the contrary, the price has been purposefully kept down, so it can be available to as many as possible. Many thousands know that Therapeutic Mineral Ice brings the promised, comforting relief at a price they can afford. Furthermore, we guarantee you relief or your money will be refunded with no questions asked. Just mail us the jar with the unused portion for a full refund. *Therapeutic Mineral Ice promises you relief, or you pay nothing.* Again, there is no cure for Arthritis and Rheumatism, but until there is, there is Therapeutic Mineral Ice. Send for it today. Start enjoying life more tomorrow . . . a tomorrow freer of pain.

MAIL YOUR ORDER TODAY!

The [illegible] Group Inc.
P.O. Box [illegible]
[illegible], PA. [illegible]

Please send me ______ jars of Therapeutic Mineral Ice in the 8-oz. (one-half pound) size. (An average 30-40 day supply). If not fully satisfied, I understand my purchase price will be refunded upon return of jar with unused portion. Enclosed is $8.95 plus $1.00 handling... total of $9.95 for each jar.

Total ______ (check or money order only).

Name ______

Address ______ Apt.# ______

City ______ State ______ Zip ______

Sorry, no C.O.D.'s, cash or charge.

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DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of complaint which the Bureau of Consumer Protection proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Federal Trade Commission Act; and

The respondent and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondent has violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues its complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent is a corporation organized, existing and doing business under and by virtue of the laws of the State of Pennsylvania, with its office and principal place of business located at 328 Easton Road, in the city of Riegelsville, State of Pennsylvania.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

I

It is ordered, That respondent Biopractic Group, Inc., a corporation, its successors, assigns, officers, representatives, agents, and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, offering for sale, sale or distribution of any "drug" or "device," as those terms are defined in the Federal Trade Commission Act, in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from representing that such product

a. Provides relief from the inflammation and joint stiffness that characterizes arthritis and other musculoskeletal ailments;

b. Stimulates the beta-endorphins present in the human body;

c. Has been praised as an effective treatment for arthritis and other musculoskeletal ailments by medical doctors, leading medical centers, professional athletic teams, or Olympic teams; or

d. Has been reported to be a breakthrough in pain management in articles in newspapers, magazines, or in television or radio news reports;

unless at the time of the dissemination of such representation respondent possesses and relies upon adequate substantiation for such representation, including, for the representations described in subparts a and b, competent and reliable scientific or medical evidence in the form of at least two independently conducted, well-controlled, double-blinded clinical studies that conform to acceptable designs and protocols, are conducted by persons who are qualified by training and experience to conduct such studies, and substantiate the reprsentations made by the respondent. *Provided, however,* with respect to any such representation set forth in subparts a and b above for over-the-counter drugs, if the Food and Drug Administration publishes any tentative or final standard which establishes conditions under which a product is safe and effective, then, in lieu of the two double-blinded clinical studies, respondent may possess and rely upon such standard (until such standard is superseded) if it substantiates the representation.

II

It is further ordered, That respondent maintain, for at least three (3) years beyond the last dissemination of any advertisement or promotional material covered by this order, complete business records demonstrating compliance with this order. Such records shall include, but not be limited to, copies of and dissemination schedules for all advertisements and promotional materials; and documents that substantiate or that contradict or qualify any claim made in advertising, promoting or selling any product covered by this order.

III

It is further ordered, That respondent notify the Commission at least thirty (30) days prior to the effective date of any proposed change in Biopractic Group, Inc., such as dissolution, assignment or sale, resulting in the emergence of a successor corporation, the creation or dissolution of subsidiaries or any other change in the corporation which may affect compliance obligations arising out of the order.

IV

It is further ordered, That the respondent shall forthwith distribute a copy of this order to each of its operating divisions, and to all present and future personnel, agents, or representatives who are engaged in the preparation and dissemination of advertisements and promotional materials and that the respondent shall secure from each such person a signed statement acknowledging receipt of the order.

V

It is further ordered, That the respondent shall, within sixty (60) days after this order becomes final, file with the Commission a report, in writing, setting forth in detail the manner and form in which it has complied with this order.

Commissioner Bailey voted in the negative. Commissioner Azcuenaga abstained.

IN THE MATTER OF

B.A.T INDUSTRIES, LTD., ET AL.

DISMISSAL ORDER, ETC., IN REGARD TO ALLEGED VIOLATIONS OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT AND SEC. 7 OF THE CLAYTON ACT

Docket 9135. Complaint, May 13, 1980—Final Order, Dec. 17, 1984

This Order affirms the Initial Decision of the Administrative Law Judge and dismisses the FTC complaint alleging that acquisition of Appleton Papers, Inc., the leading U.S. producer of chemical carbonless paper (CCP) by B.A.T Industries, Ltd. ("B.A.T") had violated Sec. 7 of the Clayton Act and Sec. 5 of the FTCA, by eliminating the potential for competition between the two companies in the U.S. CCP market. For reasons set forth in its Opinion, the Commission held that the record showed no "clear proof" that B.A.T would have entered the U.S. CCP market independently had it not acquired Appleton.

Appearances

For the Commission: *Steven A. Newborn, John V. Lacci, Sandra G. Wilkof* and *Daniel J. Yakoubian.*

For the respondents: *David Schechter,* in-house counsel, *Jay Topkis, Daniel J. Beller, Eric M. Freedman,* and *Daniel Victor, Paul, Weiss, Rifkin, Wharton & Garrison,* New York City.

COMPLAINT

The Federal Trade Commission, having reason to believe that B.A.T Industries, Ltd. ("BAT"), and Appleton Papers, Inc. ("Appleton"), respondents herein, have violated Section 7 of the Clayton Act, as amended (15 U.S.C. 18) and Section 5 of the Federal Trade Commission Act, as amended (15 U.S.C. 45) through the acquisition by BAT of the assets of the Appleton Papers Division of NCR Corporation ("NCR"), and that a proceeding in respect thereof would be in the public interest, hereby issues its Complaint, pursuant to Section 11 of the Clayton Act (15 U.S.C. 21) and Section 5(b) of the Federal Trade Commission Act (15 U.S.C. 45)), stating its charges as follows:

I. DEFINITIONS

1. For purposes of this Complaint, the following definition will apply:

Chemical carbonless paper ("CCP") is any product which uses a chemical imaging system to transfer an image from one sheet of a multipart business form to another when pressure is applied to the top sheet.

II. BAT

2. BAT is a United Kingdom company having its registered office in London, England.

3. BAT is a multinational holding company with interests in paper, tobacco, cosmetics and retailing. BAT's holdings in the United States include Brown and Williamson Tobacco Company, Gimbel Brothers, Saks Fifth Avenue and Germaine Monteil.

4. In 1978, BAT had sales in excess of 6,676,000,000 pounds sterling (or approximately $13.0 billion) and had total assets of approximately $7 billion. In 1977, BAT ranked as the 43rd largest industrial company in the world and the 11th largest industrial company outside the United States.

5. The Wiggins Teape Group, Ltd. ("Wiggins Teape"), a wholly-owned subsidiary of BAT, is the largest manufacturer of fine and specialty papers in the United Kingdom and is the largest exporter, in value, of paper products from the United Kingdom, It operates mills in the United Kingdom and several other countries. In 1978, [2] Wiggins Teape had sales of approximately 461,000,000 pounds sterling (or approximately $920 million.)

6. "Idem" brand CCP is Wiggins Teape's most important paper product and its highest profit generator. Wiggins Teape is the second largest producer of CCP (in terms of tonnage) in the world. In 1977, Wiggins Teape accounted for approximately 45% of CCP production in the United Kingdom and Europe with over $200 million in sales. Prior to BAT's acquisition of Appleton, Wiggins Teape did not produce or sell CCP in the United States.

7. At all times relevant herein, BAT sold and shipped its products throughout the United States and was a corporation engaged in commerce as commerce is defined in the Clayton Act, as amended, and was a corporation whose business was in or affecting commerce within the meaning of the Federal Trade Commission Act, as amended.

III. APPLETON

8. Appleton is a Delaware corporation having its principal office and place of business in Appleton, Wisconsin.

9. Appleton, formerly the Appleton Papers Division of NCR, is a major producer of CCP and coated papers used in the graphic arts and publishing industry. In 1977, Appleton accounted for $271 million in sales.

10. Appleton is the world's largest producer of CCP (in terms of

tonnage) and presently has approximately 55% of U.S. domestic sales. Appleton is also the major licensor of CCP technology in the world. In 1977 Appleton had $171 million in sales of CCP.

11. NCR is a Maryland corporation having its principal office and place of business in Dayton, Ohio. NCR produces and sells, among other products, computers and other business machines and systems. In 1977, NCR had approximately $1.625 billion in sales and $2.3 billion in total assets.

12. At all times relevant herein, Appleton sold and shipped its products throughout the United States and was a corporation engaged in commerce as commerce is defined in the Clayton Act, as amended, and was a corporation whose business was in or affecting commerce within the meaning of the Federal Trade Commission Act, as amended.

IV. THE ACQUISITION

13. On or about June 30, 1978, BAT, through its wholly-owned indirect subsidiary, Lentheric, Inc. (since renamed Appleton Papers, Inc.), purchased from NCR the Appleton Papers Division for a purchase price of $280 million. As a result of the acquisition, BAT acquired the assets of Appleton and the patents held by NCR relating to the manufacture of CCP, and control over the licenses issued under such patents.

V. TRADE AND COMMERCE

A. *Relevant Market*

14. The relevant product market is the manufacture and sale of CCP. [3]

15. The relevant geographic market in the United States as a whole.

B. *Market Structure*

16. In 1978, U.S. industry sales of CCP totaled approximately $250 million.

17. The U.S. CCP market is a highly concentrated industry with a four-firm concentration ratio of approximately 96%. The top two firms, Appleton and Mead, accounted for 86% of industry sales in 1977. Only five firms produced CCP in the United States in 1977, and only four of those firms produced CCP other than for their own consumption.

18. The barriers to entry into the production and sale of CCP are extremely high.

19. The production of CCP is a highly technical field that is protect-

ed by U.S. patents of Appleton and other domestic carbonless producers.

20. The high technology requirements of the CCP market constitute substantial barriers to entry into the industry. The manufacture of CCP requires encapsulation technology, sophisticated coating technology, and manufacturing know-how. It is extremely difficult to develop a commercially acceptable CCP technology. Such development is an expensive undertaking and can take anywhere from 3 to 10 years to complete. The new entrant also runs the substantial risk that its attempts to develop a viable technology will be unsuccessful.

21. The new entrant into the CCP market must make a substantial capital investment for specialized encapsulation, coating and other equipment.

C. *BAT Was A Significant Actual Potential Entrant Into The U.S. CCP Market*

22. Objective factors demonstrate that at the time of the acquisition BAT was an actual potential entrant into the production and sale of CCP in the United States.

23. From the late 1950's until BAT's acquisition of Appleton, Wiggins Teape (which was acquired by BAT in 1972) manufactured CCP under license from NCR. Wiggins Teape was one of the first manufacturers of CCP, and was the only NCR licensee outside the United States that was permitted to use NCR's encapsulation technology. The license gave BAT the exclusive right to manufacture CCP under NCR's patents and know-how worldwide, except for the United States, Canada and Japan, and the nonexclusive right to sell CCP worldwide except for the United States and Canada. The license also provided for a continuous, complete and timely exchange between NCR and BAT of all information constituting carbonless know-how and all other information helpful in the development, manufacture or sale of CCP.

24. On or about June 1, 1977, BAT gave NCR notice of termination of the aforesaid license, effective July 1, 1980. Thus, after July 1, 1980, BAT would have been free of the license provisions which restricted it from manufacturing or selling CCP in the United States. The right to use unpatented know-how would have survived the termination of the license.

25. The size of the U.S. CCP market, its high growth in comparison to other paper products, and its considerable profit potential provided substantial incentives for BAT's entry into the U.S. market. [4]

26. BAT, by reason of its size and financial resources, its independent carbonless technology, and its expertise in the production and sale of CCP, was capable, at the time of the acquisition, of entering

the U.S. CCP market in the near future by means other than the acquisition of Appleton.

27. Feasible means existed by which BAT could have entered the U.S. CCP market, including the establishment of manufacturing facilities in the United States, joint ventures or licensing relationships with U.S. firms not already in the CCP market, acquisition of a toehold firm, or export of CCP into the U.S.

28. Due to BAT's financial resources, its CCP technology and marketing expertise, and the concentrated nature of the U.S. CCP market, it is likely that BAT would have entered the production or sale of CCP in the United States through means other than the acquisition of Appleton, and that such entry would have exerted a procompetitive effect on the market and preserved the potential for the significant future deconcentration of the industry.

D. *BAT Is One Of The Few Most Likely Entrants Into The Market*

29. The CCP industry is a highly technical industry which requires that a new entrant develop a sophisticated capsule technology and substantial production expertise before the entrant can establish a position in the market.

30. BAT's longstanding license with NCR provided BAT with the most extensive knowledge of a total CCP technology in the world, excluding Appleton.

31. BAT's substantial expertise in CCP technology and its large technical staff had allowed BAT to develop elements of its own carbonless technology and to achieve technological independence from NCR, as well as to develop substantial production expertise.

32. NCR's other CCP licensees had not been given access to a total carbonless paper technology and are dependent on their licensor (now BAT) for technical assistance, especially with respect to a supply of carbonless capsules, one of the most difficult aspects of CCP production.

33. Because of the difficulty, expense and risk involved in developing CCP technology, the expense of constructing manufacturing facilities, and the scale requirements of efficient production, few firms, if any, other than BAT, are likely to enter the production of CCP for sale to others in the United States.

VI. EFFECTS

34. The effects of the acquisition of Appleton by BAT may be substantially to lessen competition or to tend to create a monopoly in the production and sale of CCP throughout the United States in violation of Section 7 of the Clayton Act, as amended (15 U.S.C. 18), and the effects of the acquisition may be unreasonably to restrain trade and

to hinder competition unduly in the production and sale of CCP in the United States thereby constituting a restraint of trade and an unfair act and practice and an unfair method of competition in or affecting commerce in violation of Section 5 of the Federal Trade Commission Act, as amended (15 U.S.C. 45), in the following ways among others:

(a) Substantial potential competition between BAT and Appleton and between BAT and other producers of CCP in the United States will be eliminated; [5]

(b) The potential for substantial deconcentration of the U.S. CCP market as a result of BAT's likely alternative entry into the U.S. market will be eliminated;

(c) The competitive benefits of internal expansion and innovation by BAT may be eliminated;

(d) The already high barriers to entry into the U.S. CCP market may be heightened or increased;

(e) The dominant position of Appleton in the U.S. CCP market may be further strengthened by virtue of BAT's financial resources, and its substantial technological and production expertise with respect to CCP; and

(f) Customers of CCP and ultimate consumers of that product may be denied the benefits of free and open competition in the market.

VII. VIOLATIONS CHARGED

35. The acquisition of Appleton by BAT constitutes a violation of Section 7 of the Clayton Act, as amended (15 U.S.C. 18) and of Section 5 of the Federal Trade Commission Act, as amended (15 U.S.C. 45).

INITIAL DECISION BY

MORTON NEEDELMAN, ADMINISTRATIVE LAW JUDGE

NOVEMBER 21, 1983

I

STATEMENT OF THE CASE

The complaint in this proceeding was issued on May 13, 1980. It charges that B.A.T Industries, Limited ("B.A.T")[1] [2] and Appleton Papers, Inc. ("Appleton"), respondents herein, have violated Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act by reason of B.A.T's acquisition of Appleton in 1978.

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[1] On July 8, 1981, the official name of respondent B.A.T was changed to B.A.T Industries PLC. Transcript 8905.

According to the complaint, the relevant product market is the manufacture and sale of chemical carbonless paper ("CCP"), a coated paper used to make multi-part business forms in which images are transferred by a chemical reaction from top to middle to bottom sheets through the application of manual or mechanical pressure. The United States as a whole is the alleged relevant geographic market.

The complaint charges that at the time of the acquisition, B.A.T through its Wiggins Teape Group, Ltd. subsidiary ("Wiggins Teape" or "WT"), a paper manufacturer with headquarters in the United Kingdom, was the largest producer of CCP outside of the U.S. Appleton was said to be the largest manufacturer of CCP within the U.S. There is no allegation in the complaint that Appleton and WT were competitors in the U.S. before the acquisition. Nor is any charge made that WT was perceived as a potential entrant on the edge of the U.S. CCP market. The complaint is grounded solely on the theory that B.A.T (or WT) was a significant "actual" potential entrant into the U.S. market. In support of this theory the complaint alleges, in summary form, the following: [3]

- The U.S. CCP market was concentrated at the time of the acquisition, and there were high entry barriers into this market.
- Objective factors demonstrate that WT had the capability and incentive to enter the United States CCP market.
- Feasible means existed by which WT could have entered the U.S. CCP market, including establishment of new manufacturing facilities, a joint venture or licensing relationship with U.S. firms, acquisition of a toehold firm, or export of CCP to the U.S.
- It was likely that WT would have pursued one of the alternative means of entry had it not acquired Appleton.
- WT was one of the few most likely entrants into the U.S. CCP market.
- The effect of the Appleton acquisition was anticompetitive in that deconcentration of the U.S. CCP market as a result of WT's likely alternative entry was eliminated, entry barriers may have been heightened, and Appleton's dominance of the U.S. CCP market was heightened.

Respondents' answer, dated July 25, 1980, denies the allegations of the complaint relating to definition of the [4] relevant product market (respondents argue for a market consisting of all papers used to make multi-part business forms) as well as the elements of the actual potential theory outlined above.[2]

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[2] The answer also raises the affirmative defense of laches and questions the Commission's in persona jurisdiction over B.A.T as well as the Commission's subject matter jurisdiction over B.A.T's acquisition of a U.S. firm. None of these affirmative defenses were pressed during the hearings or in the post-hearing briefs.

In the prehearing stage both sides were allowed extensive discovery, requests for admissions and interrogatories were answered, and stipulations were filed. Upon completion of the discovery stage, hearings were held for the purpose of ruling on objections and to receive into evidence documents which did not require supporting testimony. The case-in-chief began on February 16, 1982, and was completed on February 25, 1982. The defense case was presented between March 22, 1982, and July 9, 1982. A hearing for the receipt of rebuttal evidence was held on January 25, 1983. Surrebuttal evidence was received on February 24, 1983. The record, which was closed on February 25, 1983,[3] consists of 9,150 transcript pages and 1,337 trial [5] exhibits. During the hearings all counsel were given full opportunity to be heard and to cross-examine the witnesses.

Proposed findings of fact and briefs were filed by both sides on May 16, 1983. Answering briefs were filed on June 17, 1983, and responses were filed on July 8, 1983.

After reviewing all the evidence as well as proposed findings and briefs submitted by the parties, and based on the entire record, including my observation of the demeanor of witnesses, I make the following findings of fact:[4] [6]

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[3] The unusually long gap between the opening of the hearings and the closing of the record is attributable to the adjournments granted during the defense case and before the start of complaint counsel's rebuttal. These delays were occasioned by the extensive preparation undertaken by both sides in creating, and attempting either to discredit or to defend, the economic "models" which are treated in Findings 102 to 120.

[4] Proposed findings not adopted in the form proposed or in substance are rejected, as either not supported by the entire record, or as involving immaterial or irrelevant matters.

The following abbreviations are used throughout in citing to the record: "CX" or "CPX" (complaint counsel's exhibit or physical exhibit); "RX" or "RPX" (respondents' exhibit or physical exhibit). Testimony is cited by name of witness, followed by transcript page as in "Sheehy 3465–67." ALJ Exhibit 1, preceding the CX's and ALJ Exhibit 2, preceeding the RX's, are indices of all documentary exhibits which give description, source, status, date received or rejected, transcript reference, and in camera status.

Because of the highly sensitive cost data relied upon by both sides, especially in the economic "models" discussed in the Findings, a large volume of material, both exhibits and testimony, was placed in camera. It should be noted, however, that the Omnibus In Camera Order issued on February 25, 1982 which governs all in camera exhibits and testimony provides as follows:

> It should be clearly understood that nothing contained in this Order in any way limits the public use of this material in decisions written by the Administrative Law Judge, the Commission, or reviewing courts. While I have no intention of making unnecessary disclosures, whether or not to publish in my Initial Decision all or part of the material contained in in camera exhibits must be left solely to the discretion of the Administrative Law Judge, and I must reserve the right to exercise this discretion without consulting any party or third party.

The Omnibus In Camera Order also provides that in camera status shall be removed three years after the date on which the record was closed, that is on February 25, 1986. In camera exhibits are indicated by use of italics as in RX *355A-C*.

The appearances of the witnesses were as follows:

Name	Called By	Tr. Pages
Gary McMullen Mitchell Business Forms, Inc. (Forms Printer)	Complaint Counsel ("c.c.")	241-421

(footnote cont'd)

(footnote continued from previous page.)

Name	Called By	Tr. Pages
W. Smith Duplex Products, Inc. (Forms Printer)	c.c.	422-652
Robert H. Reeves Standard Register Co. (Forms Printer)	c.c.	655-864
P.C. Smith Mead Corp. (CCP Manufacturer)	c.c.	865-1107
George O. Langlais Nashua Corp. (CCP Manufacturer)	c.c.	1108-1196 [7]
Joseph R. Kershaw Nashua Corp. (CCP Manufacturer)	c.c	1196-1340
Ira Horowitz Univ. of Florida (Retained Economic Expert)	c.c.	1341-1642
Thomas A. Roth SCM Allied/Egry Business Systems (Forms Printer)	c.c.	1643-1802
John J. Hangen Appleton (President)	Respondents ("resp.")	1803-2355
Patrick G.M. Best Wiggins Teape (Chairman & Managing Director)	resp.	2356-2827
Vera M. Elliott Wiggins Teape (Finance & Planning Coordinator, retired, Dec. 1981, and retained to assist respondents in this litigation)	resp.	2828-3404, 6547-6982, 6983-8028
Patrick Sheehy B.A.T. (Deputy Chairman)	resp.	3405-3600
Pascal J. Ricketts B.A.T. (Director and General Counsel)	resp.	3601-3778
Joseph F. Ramey 3M Corp. (CCP Manufacturer)	resp.	3779-3917
Robert G. Hummell Burroughs Corp. (Forms Printer)	resp.	3918-4052
Robert A. Shade Shade Information Systems, Inc. (Forms Printer)	resp.	4053-4146 [8]
Maxwell A. Clampitt Clampitt Paper Co. (Paper Merchant)	resp.	4147-4220
William G. Eichner Reynolds & Reynolds Co. (Forms Printer)	resp.	4221-4294
Richard D. Mustari UARCO, Inc. (Forms Printer)	resp.	4295-4486

(footnote cont'd)

II

FINDINGS OF FACT

Identity Of Respondents And The Challenged Acquisition

1. B.A.T, the 28th largest industrial company outside of the United States, is a diversified, publicly-held, United Kingdom limited firm, with its headquarters located in London, England.[5]

2. In fiscal 1977, B.A.T had sales of approximately $11 billion and assets of $6 billion.[6] About 53% of its assets were deployed in the tobacco business, 19% in retailing, 10% in paper, 2% in cosmetics, and 16% in miscellaneous activities.[7] Operating profits in 1977 were $827 million.[8]

3. Geographically, 29% of B.A.T's fiscal 1977 sales were derived from the U.S. and Canada, 14% from the U.K., 23% from Europe, 23% from Latin America, 6% from Asia, 4% from Africa, and 1% from Australia.[9] [10]

Name	Called By	Tr. Pages
Theodore Dimitriou Wallace Business Forms, Inc. (Forms Printer)	resp.	4457-4573
Peter Pohly Beekman Paper Co. (Paper Merchant)	resp.	4574-4648
Robert W. Brogee Systemedia Group, NCR Corp. (Forms Printer)	resp.	4649-4791
Peter H. Smolka Burns, Doane, Swecker & Mathis (Retained Patent Attorney)	resp.	4792-4959 5740-5967
William C. Anderson Blake, Mofitt & Towne, Inc. (Paper Merchant)	resp.	4960-5056
Lynn Sushito-Topel Lexecon, Inc. (Retained Statistician)	resp.	5057-5249
Donald Cummings Wiggins Teape (Business Strategist)	resp.	5250-5739
William J. Baumol New York and Princeton Universities (Retained Economic Expert)	resp.	5968-6546
Robert Hietpas Appleton (Assistant Comptroller)	resp.	7381-8686 8967-9150 [9]

[5] Complaint and Answer ¶2; RX 391B.

[6] RX's 637G, K.

[7] RX 637K.

[8] RX's 637G, K.

[9] RX 637K.

4. Presently, B.A.T's U.S. holdings include Appleton (paper), Brown and Williamson (tobacco), Gimbels, Marshall Field, and Saks Fifth Avenue (retailing), Germaine Monteil and Yardley (cosmetics).[10] Sales in the U.S. and Canada were approximately $3 billion in fiscal 1977.[11] The U.S. holdings of B.A.T are administered through Batus, Inc., a Delaware corporation which is responsible for initiating and carrying out U.S. strategies and policies for B.A.T.[12]

5. Since 1970, B.A.T has owned the Wiggins Teape Group, Ltd. ("WT"), a U.K. firm which has engaged in paper merchandising and manufacturing since 1756.[13] WT's sales in 1978 were approximately $920 million.[14] WT produces and sells its products (a variety of specialty, writing, and industrial papers) primarily in Europe. In addition, it owns paper merchants in Japan, Hong Kong, Singapore, Malaysia, the Phillipines, and Indonesia, and it has paper mills or coating facilities in Australia, India, Argentina, and South Africa.[15] [11]

6. WT's line of coated papers includes the "Idem" brand of CCP. In 1977, WT sold 85,000 metric tons of "Idem"; it was the largest producer of CCP in the U.K. and Europe (about 45% of the total sales), and it was second only to Appleton among the world's CCP producers.[16]

7. After serving for two years as the European contract coater for NCR (Appleton's parent company and the U.S. inventor of CCP) WT began the production of CCP for its own account in 1956. From 1956 until May 5, 1973, (the date of the Appleton acquisition challenged herein) WT continued its production of CCP under a series of licenses from NCR. These licenses limited WT to the manufacture and sale of CP (*i.e.*, CCP made pursuant to the NCR technology) within Europe and designated areas outside of the U.S. By the terms of the licenses, WT had access to NCR's patents, technology, and know-how; moreover, in the actual operation of the licensing arrangement, WT and Appleton were in close contact about the technological problems which inevitably arise during the course of CCP manufacture.[17]

8. WT has never produced or sold CCP in the U.S.[18] [12]

9. NCR Corporation, a Maryland corporation with its headquarters in Dayton, Ohio, is primarily engaged in the manufacture of computers, office machines, and related products. In addition, through its

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[10] CX *274B* (¶2).

[11] RX's 637G, K.

[12] Sheehy 3424.

[13] Best 2376.

[14] Complaint and Answer ¶ 5.

[15] Complaint and Answer ¶ 5; Best 2377, 2383, 2393–99.

[16] Finding 90; CX's 82E, T-U.

[17] Hangen 1924–218; CX 14X.

[18] Complaint and Answer ¶ 6; Best 2413.

Systemedia Division, NCR produces business forms.[19] NCR's sales were approximately $2.3 billion in 1977.[20]

10. From experimentation begun in 1938, NCR eventually developed a commercially marketable CCP in 1954. In 1954 and 1955, it contracted out the manufacture of the product to several coaters, including Appleton Coated Paper Company, a Wisconsin paper coating firm, Mead Corporation, a major integrated paper company, and WT, the U.K. paper firm. NCR acquired Appleton in 1970, and in 1971 merged it with another former CCP contract coater and paper producer, Combined Paper Mills Co., to form Appleton Papers, Inc. as its CCP manufacturing and selling arm. In 1973, Appleton Papers, Inc. became the Appleton Papers Division of NCR.[21]

11. At the time of the subject acquisition in 1978, NCR's Appleton Papers Division had facilities for the manufacture and distribution of CCP in Appleton, Wis. (paper coating), Combined Locks, Wis. (pulp making, paper making, paper coating), Roaring [13] Spring, Pa. (pulp making, paper making, paper coating), Harrisburg, Pa. (warehousing and paper cutting), and Portage, Wis. (capsule production).[22] From its coating facilities in Wisconsin and Pennsylvania, Appleton shipped to customers located throughout the U.S.[23]

12. In 1978, the Appleton division of NCR produced approximately 213,000 tons of CCP, from which it realized revenues in excess of $236 million.[24] At the time of the subject acquisition in 1978, Appleton was by far the largest producer of CCP in the U.S., accounting for approximately 60% of the CCP resale market.[25]

13. On or about May 5, 1978, B.A.T and NCR entered into an agreement in principle for the acquisition by B.A.T of all the assets of NCR's Appleton Papers Division including plants, equipment, patents, and unpatented know-how. On June 30, 1978, the acquisition was consummated at a cost of $299 million. [14] After the acquisition, Appleton Papers Division became Appleton Papers, Inc. an incorporated Delaware subsidiary of Batus.[26]

14. With the acquisition of Appleton, B.A.T became the world's largest producer of CCP, accounting for over 40% of world-wide production.[27]

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[19] Brogee 4651–52; RX's 496Z–78, 588B.

[20] *CX 274B* (¶7); RX 588Z–19.

[21] Hangen 1812–14; CX's 2A, 82H, *274C* (¶10).

[22] CX's *35A-Z–12*; RX's 16W-X.

[23] Complaint and Answer ¶ 12; CX *274F* (¶26).

[24] CX's *274Z–23–Z–24* (¶50).

[25] Finding 49; CX 329A.

[26] Ricketts 3642; CX's 1A-Z–235, *274C* (¶12), *274D* (¶¶15, 16, 18). The acquisition was made through a Batus subsidiary, Lentheric, Inc., whose name was changed to Appleton Papers, Inc. after the acquisition.

[27] CX 82T.

Commerce

15. At all times relevant to this proceeding, B.A.T and Appleton were engaged in commerce, as "commerce" is defined in the Clayton Act, as amended, and the Federal Trade Commission Act, as amended.[28]

Relevant Product Market

16. CCP is a complex coated paper used to make multi-part business forms which record information on several sheets of paper simultaneously, thus facilitating the transmission of data to customers and throughout a business organization.[29] **[15]**

17. The typical CCP business form is made up of a set of three sheets: a top sheet coated on the back ("CB"), a middle sheet coated on both front and back ("CFB"), and a bottom sheet with a coated front ("CF"). Two-part sets omit the CFB sheet. If the business form consists of more than three parts, all of the additional intermediate sheets are CFB.[30]

18. CCP is activated when the pressure applied to the CB sheet ruptures the microscopic capsules which are coated on the back of this top sheet, thereby releasing a color former. An image is created as the color former reacts chemically with the resin-based or clay-based coreactant which is coated on the front of the CFB sheet. Simultaneously, the pressure applied to the CB sheet ruptures the microscopic capsules on the back of the CFB sheet, causing an image to be formed on the coreactant-coated CF sheet.[31] The process may be illustrated as follows: **[16]**

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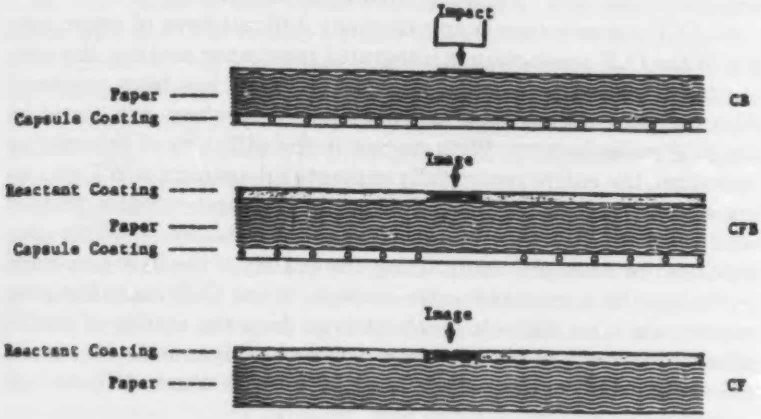
[28] Complaint and Answer ¶12; CX's *274B, F* (¶¶2, 3, 26).

[29] CX's 262A-Z-68.

[30] CX's 262Z-26, Z-29, *274D-E* (¶19).

[31] McMullen 307, P.C. Smith 914, Langlais 1117-18, 1120-21; CX's 262Z-26, *274D,E* (¶19). A product closely related to the CCP described in the text, but currently of minor commercial significance, is so-called "self-contained CCP." It combines both color former and color developer within one sheet of paper with the result that pressure applied to this one sheet will produce an image. Langlais 1118-19, Roth 1663-64; CX's 63A-C, 64A-D, 262Z-29.



Source: *RX 314H*

19. In addition to CCP, multi-part business forms are commonly made from bond paper (known in the industry as "forms bond") interleaved with carbonized tissue. Since the carbonized tissues are discarded after use, the product (a combination of forms bond and carbonized tissue) is known as one-time carbon paper or "OTC." When pressure is applied to the top sheet of the OTC set, an image is transferred mechanically (not chemically as in CCP) from the back of each interleaved sheet of carbonized tissue to the front of each adjacent sheet of bond paper.[32] [17]

20. While both CCP and OTC are used to make multi-part business forms, there is clustered around CCP a technology, a pricing structure, an industry-wide perception of competitive realities, as well as specialized customers and some unique applications, which constitute a viable relevant market for the purpose of gauging the effect of the subject acquisition (Findings 21–34).

21. Appleton and other U.S. CCP producers treat the manufacture and sale of CCP as a separate market in planning business strategy (including expansion of productive capacity) and in assessing their

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[32] W. Smith 500; CX's 262Z–12–Z–23. For purposes of this initial decision, I have treated together, as apparently the forms and CCP industries do, OTC and mechanical transfer paper. Mechanical transfer paper (not a significant factor in the multi-part forms industry) uses in place of carbon interleaf a bond paper coated with carbon material. McMullen 315–16, W. Smith 435, Roth 1671.

competitive strength.[33] Similarly, B.A.T analyzed the Appleton acquisition in the context of a market consisting only of CCP competitors, and concluded that "Appleton dominates this market."[34]

22. CCP manufacture is an extremely difficult form of paper coating. If the CCP production is integrated into paper making, the coating takes place after a bond of paper or "web" has been produced. Alternatively, rolls of base paper produced elsewhere are coated by the CCP manufacturer. With respect to the difficulty of this coating operation, the entire record fully supports the opinion of WT managers who believe that CCP "is [18] easily the most complex product which is made in high volume in the paper industry."[35] While complexities (for example, maintaining the quality of the base paper and perfecting the coreactant) exist throughout the CCP manufacturing process, the most difficult problems arise from the costing of the CB sides which involves the microencapsulation of dyes and solvents and the subsequent coating of the base paper with these delicate capsules.[36]

23. The microencapsulation and coating of capsules, which is at the heart of CCP technology, requires unique facilities, custom-designed equipment, and specialized raw materials [19] produced under proprietary arrangements with chemical companies.[37]

24. CCP manufacture also requires the support of an especially rigorous level of quality control and testing, as well as an extensive and continuous research effort. These requirements of CCP, which are unique in the paper industry, demand that specially trained manufacturing, technical, and research personnel be employed.[38]

25. The extraordinary demands of CCP manufacture would be wasted if expensive CCP capability were used for a less demanding product

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[33] P.C. Smith 891–92, 980–81, Kershaw 1220–21, 1227–28, 1308–09; CX's 7B, 10F-"O", 17H-I, *29V, Z–16, 32M, V, Z–7,* 33J, Z–11–Z–14, 34J, 41C, "O", *48D, P, 87W,* 91Q-S, 100N-P, 173C, 184Z–42–Z–47, 188A-"O", 209A-W, 210, 212B-C, 220B.

[34] CX 82H. *See also* CX's 2M-N, 47C.

[35] CX 36A.

[36] Langlais 1130–31; CX's 12Z–9–Z–12, 13V-Z–8, 262Z–31–Z–40; RX's 293L, *314G.* At the heart of CCP technology is the creation of—

> . . . discrete capsules for isolating the color forming components from the color developers until pressure or impact breaks the capsules, releasing the dyes and allowing them to react and to form an image.
>
> The capsules range in size from roughly 3 microns to 15 microns, depending upon the specific [CCP] system. (A microm is equal to 0.000001 meters or approximately 0.0004 inches.) By way of comparison, a single capsule would be one hundred times smaller than the period at the end of this sentence.

(CX 262Z–27)

[37] P.C. Smith 870–71, 878, 880–81; CX's 10F-K, 13V-Z–6, 100H, 254Z–8–Z–11, 257P-Q, *274E-F*(¶¶20–22,25); RX's 262A-N.

[38] Elliott 2907; CX's 10F-K, V-W, 27J, 65, 68N, 100M, 101F, 126G, *274Z–35*(¶53); RX's 262L-N. Appleton's research staff consists of over 80 technicians (CX's 126J-K) and its research facilities represent "a major investment in proprietary equipment for carbonless paper." CX 126L. *See also* CX 2V. Appleton has had as many as 50 CCP research projects underway at the same time. CX's 126"0"-P. The technical requirements of CCP go beyond the factory and laboratory. Technical service representatives are trained to work with forms manufacturers on the intricacies of CCP printing. P.C. Smith 896–97; CX's 2"0", 3M, 10V-W, *31Z–1.*

such as OTC.[39] Thus there is no reliable evidence that CCP equipment is used for OTC manufacture.[40] [20]

26. CCP paper is sold in rolls to printers of multi-part business forms who use CCP to make either stock (standard) or custom (individualized) forms, and either unit sets (forms designed to be filled out individually as they are torn from a glued stub) or continuous forms (containing perforations enabling many forms to be filled out sequentially; for example, as the paper is fed continuously through a computer or specialized printer).[41]

27. The main other channel of CCP distribution is through sheet sales which flow from CCP manufacturer to paper merchants who resell to commercial printers (so-called "quick printers") or to company in-plant printing facilities for use in making up unit sets.[42]

28. The sheets produced by CCP manufacturers, which represent about 30% of all CCP production, and is higher-priced than CCP rolls, are non-substitutable products. The customers for CCP sheets—the aforementioned "quick printers" and in-plant printing operations—are for all practical purposes [21] precluded from turning to OTC even if the price of CCP were to be raised substantially in relation to OTC.[43]

29. The multi-part forms printers who purchase CCP in rolls (in contrast to sheet sales to merchants for resale to "quick printers") can use either OTC or CCP to make forms suitable for most applications.[44] This functional overlap, however, has no eliminated the price differential which has existed between CCP and the combined ingredients (mainly bond paper and tissue) used by the forms manufacturers themselves to make OTC.[45] [22]

30. The premium paid for CCP over OTC persists because forms printers place a high value on neatness and cleanliness, considerations which carry forward into the forms market itself where CCP

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[39] CX *35Z–12. See also* P.C. Smith 888.

[40] *See* P.C. Smith 874–76, 880; CX 254Z–9. There is no evidence that OTC equipment has been successfully converted to CCP production. *See* P.C. Smith 871, Langlais 1132–34, Kershaw 1225–26, Hangen 2087–88.

[41] McMullen 304–06, Roth 1659–60, Pohly 4594–95; CX's 138D-F, 262H-J. Large rolls are also sold to converters for the manufacture of teletype rolls and other smaller rolls. CX 38W.

[42] CX 38W. There are presently over 100,000 in-plant printers. P.C. Smith 1002.

[43] McMullen 320–21, Reeves 681, 825–26, P.C. Smith 898–99, 985–86, Kershaw 1204, 1223, 1231, Roth 1668–70, Clampitt 4207–08, Pohly 4602, 4606, Anderson 5013; CX's 16Z–59, 22, *29Z–9, 31Z–7, 33Z–7,* 210A-Z–16, 492M. In order to use OTC, the sheet printer would have to cut the carbon paper into the size appropriate for the order, interleave the carbon with the form paper, glue the form together, and perforate the glued form for later removal of the carbon. This process has been rejected since it is labor-intensive, time-consuming, and requires special equipment. McMullen 300-01, 320; CX's *66M,* 213C.

[44] Hummell 3945, Shade 4062, Clampitt 4159, Mustari 4399. In some applications, however, CCP has taken over to the virtual exclusion of OTC. For example, unattended printers, such as those used in automated tellers and teletype machines, have been designed to use only CCP. CCP is the dominant multi-part material used in minicomputers. CCP is the preferred material in restaurants, hotels, and hospitals where cleanliness is a consideration. CCP is also preferred in businesses in which security is a major consideration. McMullen 312–20, W. Smith 440–47, 558–59, Roth 1665–66, Hangen 1964–65, Ramey 3883, Hummell 3942–44; CX's 18"O", 20B. The record, however, does not reveal what percentage of total CCP production is represented by these applications.

[45] McMullen 341–42, W. Smith 465, Reeves 675; CX's 38I-J, 41L, 70, 79A-Z–11. In 1982, the difference between CCP costs and OTC costs to the forms printer was between 20% to 30%. W. Smith 464-65, Reeves 675.

forms are traditionally priced higher and independently of OTC forms. In a word, the forms printers and their customers (the forms users) are willing to pay a higher price for CCP in order to avoid the smudging and inconvenience associated with either carbonized tissues or bond paper with a carbon backing.[46]

31. The ability of CCP manufacturers to maintain this premium and yet switch a significant number of customers from the more widely-used OTC does not turn on small changes in the price of either of the two products. H.F. Rance, the father of WT's CCP business and a seasoned follower of trends in the U.S. market and elsewhere,[47] observed: **[23]**

> In my experience the amount of the price differential has little effect upon the penetration rate provided it is between 15% and 50%. In other words, a price differential of about 30%, balanced against the quality benefits of CCCP and allowing for the other subordinate constraining factors, determines the penetration rate at a figure of 1% per annum, and this penetration rate is not significantly reduced even if the price differential is doubled; nor is it significantly increased even if the price differential is halved.[48]

32. Further contributing to the lack of price sensitivity between OTC and CCP, is the fact that once a decision to use a CCP form has been made, customers of the forms manufacturers rarely switch back to OTC on the basis of changes in the price spread between the two products.[49] **[24]**

33. Given the leverage which they have over sheet users who realistically cannot turn to a substitute, and the perception of CCP customers generally (*i.e.*, forms printers and forms users) that CCP is the technologically superior product which legitimately commands a substantial premium, in the day-to-day operations of CCP manufacturers, pricing decisions are not made on the basis of OTC prices, and the prices of the two products do not move in tandem.[50]

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[46] McMullen 312–13, 327, 355–56, W. Smith 465–66, Reeves 644, 675–77, 819–21, Kershaw 1222, Eichner 4275–76; CX's 12H,Z–22, Z–28, *66M*.

[47] Rance's career was described as follows by one of respondents' attorneys:

> Dr. Rance served WT for over forty years, some twenty of them as a director. At the time of his retirement, on January 31, 1975, he was in charge of all of WT's strategic planning and research functions. During his tenure at the company, he had acquired technical expertise in carbonless paper and had conducted all of WT's license negotiations with the NCR corporation. Accordingly, when he retired, at a time of considerable uncertainty in WT's relationship with NCR, WT took steps to ensure that Dr. Rance's knowledge and experience would remain at its disposal (affidavit of Paul S. Shrank attached to Respondents' Opposition to In Camera Examination of Certain Documents, 8/31/81). *See also* Best 2378–79.

The steps taken by WT to retain Dr. Rance's knowledge included a series of consultancy agreements and use of his services as a behind-the-scenes expert in this litigation.

[48] CX 12Z–25. *See also* Horowitz 1353–56, 1516–20, 1522–23, 1599.

[49] McMullen 331–32, 335, 337–38, 354–55, W. Smith 468, 644, Reeves 821–22, Kershaw 1230, Roth 1770–71, Clampitt 4209, Mustari 4485, Anderson 5038. Thus, even in times of recession, users do not switch from CCP to OTC on any significant scale. CX 12Z-25.

[50] W. Smith 466–67, Reeves 827, P.C. Smith 891–92, 905, 994, Kershaw 1220–21, 1227–29, 1231, Ramey 3879–80; CX's 11A-"O", 12Z–25, 41F-G, 43A, 44C, 91Z–20, 217A-C. Similarly, there is no relationship between the price charged by printers for CCP forms and the price charged for OTC forms. McMullen 356, W. Smith 466, Reeves

(footnote cont'd)

34. No weight can be given to the econometric analysis of Appleton's own elasticity, the CCP industry's elasticity, and the cross-elasticity between CCP and OTC, which was prepared for litigation by respondents' retained expert, Dr. William J. **[25]** Baumol. Baumol's entire exercise, as summarized in RX 562, is grounded on the assumption that CCP buyers make decisions about whether to switch to other suppliers of CCP, or to switch between CCP and OTC, in a period ranging from four to six months after a price change is announced. Baumol, who had no expertise in the CCP industry ("I am not qualified to report what the industry does")[51] admitted that he knew of no evidentiary support for his "lag" hypothesis and he conceded that his study was useless if his assumption was in error.[52] As it happens, the only support for this "lag" assumption is Baumol's own bootstrap argument that without it his studies produce "statistical nonsense."[53] But no Appleton or B.A.T official (or any other CCP executive) testified about the existence of a four to six month "lag" in actual practice. Moreover, in a pre-litigation report on the feasibility of a study of Appleton's own elasticities in which a similar four month lag was **[26]** applied,[54] Appleton executives were warned of the bias and limitations inherent in the econometric approach to elasticities.[55] This earlier research (whose reliability was no more firmly established on the record than Baumol's study) reached the conclusion that Appleton's own elasticity was 1.1 which would indicate that Appleton could raise prices with little risk to itself.[56] In contrast, Baumol's construct produced a cross-elasticity coefficient of 4.19 and an Appleton own elasticity of 16.11. These results, which even came as a surprise to Baumol ("I can literally say that I have never for any firm found an elasticity higher than this, even for individual gasoline stations"),[57] suggest that the underlying data lends itself too easily to adversarial gerrymandering. This is corroborated by the fact that using Baumol's own

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819–20, Eichner 4275. The fact that several witnesses testified that "if" or "when" CCP and OTC were priced at the same level, even more users would switch to CCP (Reeves 748, Roth 1691, Kershaw 1297–98, Hummell 3945–46) tells us little about the pricing discretion enjoyed by CCP manufacturers who, in fact, have historically priced their product above and independently of OTC while achieving a growth rate which far exceeds the growth of OTC. CX's 28G-H, *29"O", Z-6, 31"O", Z-4, 32Q, 33E, Z-6,* 38Z–32, 58N, 191M-P, 209Q. For the period 1972 to 1979, the average annual growth for CCP was 17% while forms bond grew at 9%, and carbonizing tissue grew at a rate of 4%. CX 60J.

[51] Baumol 6291. *See also* Baumol 6404, 6409–12.

[52] Baumol 6157–58, 6292–93, 6340, 6345–46.

[53] Baumol 6342. The record suggests at least two other reasons why the study would produce "statistical nonsense" besides the insertion or removal of arbitrary "lags." The proxies used by Baumol for both CCP and OTC are questioanble (*see* Baumol 6165–66, 6176–77, 6190, 6192–93) and there is strong evidence of a multicolinearity problem traceable to the identity of Mead and Appleton prices and the clear record proof that customers in fact do not switch CCP suppliers on the basis of price (*see* Tr. 6042, agreement of respondents' counsel, and Baumol 6039–42, 6046–47, 6202–03, 6206–09).

[54] CX's 372A-M.

[55] CX 372G.

[56] Baumol 6367. *See also* CX's 417, 454A-E for another Appleton pre-litigation estimate of own elasticity which ranged from 1.32 to 2.65.

[57] Baumol 5999.

annual regressions, complaint counsel's econometrician produced exhibits showing a cross-elasticity coefficient of -.01.[58] Moreover, by applying various monthly "lags"—0, 1, 2, 3 months— [27] which are as plausible on the basis of this record as Baumol's four to six month lag, the same data used by Baumol produces own elasticity and cross-elasticity coefficients which are not statistically different from zero.[59] In sum, because the validity of Baumol's econometric study was not established on the record, and because his testimony was largely based on the study, I have not relied on any of the opinions expressed by this witness.

Relevant Geographic Market

35. The relevant geographic market in which to evaluate B.A.T's acquisition of Appleton is the United States as a whole.[60]

Concentration In The U.S. CCP Market

36. The first U.S. company to challenge NCR as a CCP producer was 3M Corp. which entered the market in 1962 with a self-contained form of CCP sold under the brand name "Action 100." "Action 100" has achieved limited acceptance.[61] Beginning in 1966, 3M entered into the manufacture of standard, transfer-type CCP, first with the use of contract coaters and then through the purchase in 1971 of a coating plant in Nekossa, [28] Wis., which had formerly done contract coating for NCR.[62] 3M, which is not integrated into paper making, lost money from its entry in 1962 until 1974.[63] Since then, its profits have averaged about 6% before taxes.[64] CCP is an infinitesimal segment of 3M's overall business,[65] and it is not aggressively promoted by 3M.[66]

37. The next entrant into the U.S. CCP market was Nashua, a firm generally engaged in paper coating and converting. Nashua embarked on CCP development in 1965 with a clay-based CCF system which it began selling five years later with limited commercial success.[67] Subsequently, it converted to a resin-based CF sheet.[68] Nashua is not integrated into paper making and presently most of its CF is

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[58] CX's 432, 450. *See also* CX 433 for a measure of the cross-elasticity of OTC and CCP using Baumol's data. It shows a range of values between .44 to 1.14.

[59] Baumol 6318–19, 6331–34, 6337–38.

[60] CX *274F* (¶ 29).

[61] Ramey 3792–93, 3798.

[62] Ramey 3794–95.

[63] RX *609*.

[64] RX *609*. 3M turned a profit by concentrating on sheet sales during a 1974 shortage. To this day, 3M has made no profit on roll sales. Ramey 3824–25, 3832.

[65] Ramey 3889.

[66] Reeves 711–12, Roth 1675.

[67] Langlais 1117, 1135, 1193, Kershaw 1202.

[68] Langlais 1128; RX 223. The conversion was made over a two-year period, but could have been accomplished more quickly if the project had been assigned a higher priority. Langlais 1129.

coated by James River Company.[69] Nashua makes the other components of its CCP product in its [**29**] Merrimack, New Hampshire, facility.[70] Nashua cannot match either Appleton or Mead in the quality of finished product or the efficiency of its production.[71] Nashua's commitment to CCP has been half-hearted at best.[72] During most of the period 1976–1982, Nashua's CCP business has shown deep losses.[73]

38. Mead, an integrated paper company with internal access to trees, pulp, and paper, began its production of CCP as a contract coater for NCR in 1954.[74] In 1971, Mead was given a license by NCR to manufacture CCP for its own account. Mead paid royalties to NCR for the use of NCR's patents and technology from 1971 through 1978.[75] Mead has also licensed patented technology from Fuji, a Japanese CCP producer.[76] Mead's CCP operation is successful and highly profitable.[77]

39. Champion International, a large paper company, entered the U.S. CCP market in 1969 with its own technology. Although [**30**] it is fully integrated into paper manufacturing and has substantial financial and marketing resources, Champion was unable to overcome the technical problems of CCP production.[78] Throughout its existence as a CCP producer, Champion was plagued by quality problems, and because its product was not commercially accepted, Champion left the CCP market in 1976.[79]

40. Boise Cascade, another large integrated paper company, obtained a license from Nashua in 1975 to produce and sell CCP west of the Mississippi.[80] Under Nashua's unpatented, proprietary technology, Boise began manufacturing CCP in 1978 but a west coast paper strike interrupted production soon after it began. The strike was followed by a series of quality problems and Boise did not resume production until 1980. Boise only produces CCP rolls for sale to the west coast multi-part forms printers.[81]

41. In addiion to the CCP manufacturers described above who manufacture for resale, Moore Business Forms, a Canadian firm which is by far the largest producer of business forms in the world, has integrated backward into CCP production. Moore, [**31**] which has

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[69] Kershaw 1213; RX *304Z–7*.

[70] Kershaw 1213.

[71] W. Smith 469, Reeves 711; CX's 12Y.

[72] Kershaw 1251–52.

[73] RX *756B*.

[74] P.C. Smith 940–44, Hangen 1813.

[75] P.C. Smith 1089–90.

[76] P.C. Smith 1089–90.

[77] P.C. Smith 1082–87.

[78] Ramey 3876.

[79] CX's 57C, *66X*, 255Z–44.

[80] Hangen 1902; CX *66Y*; RX's 512A–V, 565B.

[81] Reeves 710; CX *29Z–11*, 254Z–29; RX's *121Z–1*, 134.

about 30% of the U.S. business forms market and is almost five times the size of its closest U.S. competitor, developed a CCP product in the 1960's using a clay-based CF.[82] Moore's CF is currently made by James River, Great Northern Nekossa, and Fraser, integrated paper companies.[83] In addition, CCP has been produced for Moore by Appleton as a contract coater. In this segment of its business, Appleton uses Moore's own CCP formulation.[84] Moore produces some of its CCP requirements in its own plants.[85]

42. Moore does not resell any CCP in the U.S. Its internal production (both in-house as well as the CCP obtained from contract coaters) is used exclusively in the manufacture of multi-part business forms.[86]

43. Mead, which as indicated in Finding 49 is the second largest producer of CCP for resale, has been attempting to develop a CCP system (called "OPAS") which would allow forms [32] printers to coat bond paper themselves either on or off the printing press.[87] The system was designed for the low end of the CCP market.[88] Its technological feasibility has not been proven,[89] with the result that the system has met with practically no commercial success,[90] and WT has been advised that "OPAS" has limited potential.[91]

44. Like Mead, Frye ("a very small outfit") has been experimenting since 1978 with the development of a non-encapsulated CCF coating system which could be used for in-house coating by forms printers.[92] As it presently formulated, the Frye system has severe technological limitations and has received minimum acceptance;[93] in fact, it has been licensed to only one forms printer, Shade Information System, which uses [33] the Frye system on specialized presses to make low-quality stock tab forms.[94]

45. "Actionprint," 3M's on-press CCP system provides forms printers with pre-coated CB sheets and CF materials.[95] The system has limited applications ("spot" coating), has been plagued with technical difficulties, and has been so unsuccessful that 3M has discontinued all

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[82] W. Smith 551–52, Reeves 670–71; CX 330X. After ten years of work (CX *103D*), and the expenditure of $3 million a year on development (CX 15V), Moore still has technical problems (CX 265D), and its in-house produced CCP is confined to use in the lower-end forms applications. CX's 255Z-20-Z-21.

[83] CX 553X.

[84] CX 255Z–13.

[85] RX *354G*.

[86] CX's 3K, 50G; RX's *354F-H*.

[87] Every aspect of OPAS is controlled by Mead, and its use simply increases Mead's market share. W. Smith 482, P.C. Smith 1079, Horowitz 1634–35.

[88] CX 4C. For the scale problem presented by this application *see* W. Smith 480–81.

[89] W. Smith 478, 481, 611–12, 624–27, 640, Roth 1687–90, Eichner 4256–57; CX 16Z–39.

[90] W. Smith 639, Reeves 702, Roth 1693, Dimitriou 4508, 4534–35; CX's 16Z–39, 314B, 533X.

[91] CX 14Z–9.

[92] CX 15Z–4; RX's *120Z–9*, 128B, 668.

[93] Reeves 721, Langlais 1181, Kershaw 1235, Roth 1676–77; CX's 264H, 277H-J.

[94] Shade 4124–28. There is evidence that the Frye system is no longer being offered to other printers because of CB offsetting and image stability problems. CX's *404G, 406*.

[95] RX's 161A-L, 492A-D, 598A-C.

promotion to the point that the product has virtually been withdrawn from the market.[96]

46. With the exception of Moore, the in-house CCP coating experiments of all other forms manufacturers have not met with discernible success.[97] **[34]**

47. In calculating market shares in the CCP market, it is proper to exclude Moore's in-house production. Moore is not regarded as a competitor by the CCP producers for resale. Patrick Best, the chairman of WT, gave the following persuasive testimony on this point:

> Q. Why should you make a distinction between resale and for in-house use?
>
> A. I think there is all the difference in the world. The person who is making carbonless paper for their own purposes and printing themselves such that to them it is a totally integrated process, I mean, they are doing their own coating, not their own paper making, but it is integrated as between coating and the printing of carbonless forms, is in a very different position to Wiggins-Teape or Mead or any of the family of carbonless papers producers that I was addressing myself to, because we are competing in the open market with each other for sales to printers and merchants and so on. The in-house user, like Moore, is in a very different situation.
>
> Q. You don't really consider Moore a competitor of yours, do you?
>
> A. No.[98]

Best's perception of competitive realities is fully consistent with the record facts respecting the role of Moore in the CCP marketplace. Moore has never sold CCP to forms printers **[35]** and has no intention of doing so; Moore's internal production of CCP has had no discernible price-limiting effect on Appleton; and Moore itself remains largely dependent on the CCP manufacturers for its own supply of the product.[99]

48. There is no real dispute about the high level of concentration in the U.S. CCP resale market. In their answer to interrogatories, respondents said that they "will not dispute that in 1977 Appleton accounted for approximately 53% of domestic CCP sales and approximately 56% of domestic CCP production."[100] Respondents further said they "will not dispute that in 1977 the two leading producers of CCP, Appleton and Mead, accounted for approximately 82% of all

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[96] McMullen, 369–75, Reeves 705, Roth 1700; CX's 28U, 264H.

[97] CX 15Z–4. At the time of the trial, for example, Burroughs had still not developed a commercially proven CB technology. Hummell 4006; *see also* CX 101C. Wallace had largely abandoned its development of standard CCP (Dimitriou 4516–17, 4535) and is only in the experimental stage with an alternative method. Dimitriou 4539–40. UARCO, too, was no longer attempting to develop its own CCP system. Mustari 4402–03. Duplex had discontinued all efforts to produce CCP in-house. W. Smith 477, 483. Allied/Egry has exhausted all avenues of in-house coating. Roth 1773–74. This roster of CCP failures includes NCR's own Systemedia Division, a forms printer which by the terms of the NCR-B.A.T agreement for the sale of Appleton was given a license to manufacture CCP for in-house use after 1981. The license was confined, however, to know-how in existence at the time of the acquisition. Hangen 1986–87.

[98] Best 2659–60. *See also* Horowitz 1386 and CX's *32U, 33Z–14* for Appleton's recognition of a resale market.

[99] Findings 42, 62, 81.

[100] CX *274F* (¶31).

domestic CCP sales and approximately 81% of domestic CCP production."[101] In a meeting of the key Appleton executives on February 8, 1980, the CCP market was described as follows:

> Appleton Papers has about a 58% share of the carbonless market. As many of you realize—Mead is our No. 1 competitor. Its share of the market: about 30%. 3M is our No. 2 competitor. And Nashua is No. 3. Their combined share: About 10%. The No. 4. competitor would have been Boise Cascade, but as of this month, it had not yet resumed carbonless production following its strike. [36] It was at 1%. Frye and other in-plant coater programs represent .5 of a percent.[102]

49. Complaint counsel's proposed universe and market shares, as shown in Table 1 below, are consistent with respondents' own admissions as outlined in Finding 48[103] and give an adequately reliable picture of the CCP resale market:

Table 1
U.S. Producers Share of CCP Resale Market In Percent Of Total Tons

	1975	1976	1977	1978	1979	1980
Total Tons	219,500	254,000	277,000[104]	334,000	359,000	389,000
Appleton	57.0%	60.0%	61.0%	64.0%	64.0%	62.0%
Mead	23.0	26.0	26.0	25.0	25.0	26.0
3M	11.0	9.0	8.3	6.9	6.1	5.7
Nashua	7.3	4.0	4.3	4.5	4.5	4.4
Boise	0	0	0	.3	0	1.3
Champion	2.0	1.0	0	0	0	0
Frye	0	0	0	0	.3	.5

Source: CX 329A [37]

50. Concentration ratios among the top 2, top 4, and top 8 firms in the CCP resale market (*see* Table 1) are shown below:

Table 2
Leading Firm Concentration In CCP Resale Market

	1975	1976	1977	1978	1979	1980
Top 2 firms	80.0%	86.0%	87.0%	89.0%	89.0%	88.0%
Top 4 firms	98.3	99.0	100.0	100.0	99.6	98.1
Top 8 firms	100.0	100.0	100.0	100.0	100.0	100.0

Source: Table 1[105]

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[101] CX's *274F-G* (¶32). *See also* CX 4B.

[102] CX's *34J*, 220B. According to Appleton's own records, its 1977 share of the resale market was 61.6%. CX 219.

[103] The discrepancy between Table 1 and estimates appearing in Finding 48 are traceable to the attribution to Appleton as a contract coater of CCP produced for Moore and the inclusion of exports.

[104] The dollar value of CCP sales was approximately $300 million in 1977. RX 16G.

[105] Respondents' "production" market, which reflects the internal production of Moore, and attributes to Moore all CCP produced for it by Appleton as a contract coater, shows Appleton with 48.7% of the market and a 4-firm

(footnote cont'd)

51. Using the Herfindahl-Hirschman Index of concentration, which shows the sum of the squares of all firms listed in Table 1, concentration is as follows: [38]

Table 3
Herfindahl-Hirschman Index (HHI) Of Concentration In CCP Resale Market

	1975	1976	1977	1978	1979	1980
HHI	3946	4374	4484	4789	4778	4573

Source: Table 1

Competition In The U.S. CCP Market

52. Given the high level of concentration in the CCP market, whether calculated by traditional concentration ratios or HHI, respondents have the burden to produce rebuttal evidence showing that the market has been performing competitively. The persuasive evidence in the record is all to the contrary (Findings 53–63).

53. The CCP market has a high technological entry barrier as indicated in Findings 16–18, 22–24, 36–41, 43–46, 74, 86, 91.

54. In Appleton's own view, its dominant position in the tightly barricaded CCP industry can be used to lead the industry to higher prices. Planning ahead to 1981, an Appleton official observed in 1976—

> Price leadership is a phrase which has been used to indicate the ability bestowed upon the "strong one"—or leader of an industry. NCR Paper [Appleton's brand name] is the leader [39] and the strongest in total sales and product design. . . . It is our forecast, NCR Paper Sales can lead the chemical carbonless industry to a higher price level by remaining the leader.[106]

55. Appleton announces its price changes four to six weeks in advance for the very purpose of giving its few competitors time to get into line.[107]

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concentration ratio of 95.3% at the time of the acquisition. RX *251*. The 1978 HHI in respondents' version of the market was 4336. Complaint counsel's production market, which attributes to Appleton all CCP produced for Moore, shows Appleton's market share declining from 61.0% in 1978 to 51.0% in 1980 while Moore's own production grew from 4.8% to 15.0% during the same period. Concentration ratios in complaint counsel's production market are as follows:

	1978	1979	1980
Top 2	84.0%	76.0%	73.0%
Top 4	95.4%	94.5%	92.6%
Top 8	100.0%	100.0%	100.0%
HHI	4336	3680	3357

(CX 329B)

[106] CX 218C. *See also* CX's 91R, 532J-K. As part of its evaluation of the Appleton acquisition, WT cited the need to maintain a 50% market share "To ensure stability and real market leadership." RX 16Z–1.

[107] CX 44C; *see also* McMullen 343.

56. The Appleton price changes are planned long in advance as part of its annual budgeting process and have been put into effect even when immediate market conditions suggest a contrary strategy.[108] To illustrate, Appleton has raised its prices recently in the face of a deep recession and falling raw material costs.[109]

57. Most price changes (and there have been relatively few in the history of the CCP industry) have been initiated by [40] Appleton.[110] Occasionally, Mead has taken the lead.[111] Nashua and 3M consistently follow Appleton's and Mead's pricing,[112] and thus for all practical purposes, there is no price competition in the U.S. CCP market.[113]

58. Concessions from list prices are rarely given in the CCP industry.[114]

59. While CCP producers compete in quality, even when it was faced with a serious quality problem, Appleton's policy is to resist price cutting.[115]

60. Appleton's discretionary power over the price of CCP is not restrained by the demand elasticity of the product. Thus, pricing decisions are made on the assumption that small [41] increases in the price of CCP will have little effect on the quantity sold.[116]

61. Appleton's operating profit margins, in the words of its own officials, are "extraordinarily high by paper industry standards."[117] Appleton is more profitable than most of the paper industry;[118] in fact, between 1972 and 1980, Appleton consistently earned profits on its carbonless paper in excess of the profits earned by the 500 largest firms in the U.S. as measured by return on shareholders' equity.[119]

62. Moore began in-house coating because Appleton's prices were inordinately high;[120] there is no evidence, however, that Moore's efforts have had dampering effect on Appleton's pricing discretion.[121] **[42]**

63. The history of the CCP industry has been marked by frequent

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[108] Horowitz 1624–25; CX 454A.

[109] McMullen 343–45, Reeves 685–86, Horowitz 1404, 1407, 1636, Roth 1678–80.

[110] McMullen, 343, Kershaw 1228, Roth 1677, Anderson 4997–98; CX's 42B, 254Z–1, 259Z–13, 449A–D.

[111] Reeves 682–83, Kershaw 1228.

[112] Kershaw 1229, 1258, Hangen 2208, Ramey 3879–80, Mustari 4473–74.

[113] McMullen 342, Reeves 682–85, Kershaw 1228–29, Roth 1673–75, 1680, Dimitriou 4564; CX's *29Z–3, 33"O"*.

[114] Reeves 687, Roth 1673, 1678, Hangen 2208, Mustari 4473–74; CX 44E.

[115] *See* Hangen 2208, 2220–23; CX's 284B-C, 309C.

[116] CX's 417, 454A-E. *See also* Horowitz 1353–54, 1387–88.

[117] RX 179C. *See* CX's 183Z–1–Z–2, Z–4–Z–7, 528C; RX 726B for evidence of stability of Appleton's gross profits (between 26.5% and 29.0%) from 1974 to 1980.

[118] *See* CX's *469*, 471.

[119] Horowitz 1405. Appleton's 1981–1985 five year plan projects stable profits. CX *32Z–77.* Mead, too, had realized excellent profits from its CCP business. CX 188C.

[120] Horowitz 1406, 1575; CX's 15U, 27G.

[121] For example, at the time of the trial in this matter, bond paper was selling at 10% to 15% off list. There was no corresponding off-list selling in CCP; in fact, CCP producers had recently raised list prices. McMullen 343–45, Reeves 685–86. One forms printer testified that the treat of in-house coating "surely should" exert pressure on Appleton and Mead to reduce prices (W. Smith 627–28) but within one month of calling the threat of Moore's in-house production to Appleton's attention, the price of CCP went up. W. Smith 637. *See also* Horowitz 1397–98.

periods of shortages during which supply had to be allocated.[122] During the deep recession of recent years the industry has been in a state of over-capacity.[123] Even in the face of this condition, however, prices have remained firm.[124]

B.A.T's And WT's Interest in the U.S. CCP Market

64. Because of its political stability, vigorous growth and high profits in industries familiar to B.A.T, and the absence of bars to foreign investment or profit remittance, the U.S. generally is considered a prime geographic area for B.A.T investments as shown by its aggressive U.S. acquisition and expansion policies.[125] In fiscal 1977, for example, B.A.T [43] reported capital expenditures in the U.S. of approximately $77 million, which was 32% of its total capital expenditures for that year, and more than its outlay in any other country or area including the U.K. or Europe.[126]

65. B.A.T's paper-making subsidiary, WT, had special reasons for looking to the U.S. CCP market. About 90% of all CCP production is centered in the North America, Japan and Europe.[127] The North American market (essentially the U.S.) accounts for approximately 45% of the world's tonnage, and is one and a half times larger than the European CCP market.[128] While WT was dominant in Europe,[129] by 1978 it saw a threat to that domination from Japanese exports.[130] Japan, on the other hand, was effectively foreclosed to any outside competition.[131] As an international company, this left the U.S. as the only fertile field for expansion of its CCP business which clearly constituted WT's main growth potential.[132] [44]

66. Consistent with B.A.T's general interest in the U.S. and WT's search for ways to expand its CCP sales, WT followed a policy of surveillance of the U.S. CCP market with the result that it had accumulated detailed knowledge about the opportunities and needs of the market.[133] Specifically, WT knew that not only was the U.S. CCP market huge in absolute terms, but it was expected to grow. Estimates made for WT prior to and after the acquisition placed CCP growth at about 15% annually for the next several years, a significantly higher

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[122] CX's 2M, 4F, 16Z–37, 71A, 124A, F, 209E-F, 254Z–5, Z–32, 259"O".

[123] *See* note 137, *infra.*

[124] McMullen 343–45, Reeves 685–86, Roth 1673–74, 1678–80, Hangen 2209–10. *See also* CX 91R for statement of Appleton policy "to avoid precipitating price wars during times of excess capacity."

[125] CX 49C. B.A.T does not canvass an unlimited number of potential investments to select the most profitable: it concentrates on opportunities in familiar fields. CX 128C.

[126] RX 637H.

[127] CX *48D;* RX's 16E, T.

[128] RX 16T.

[129] RX 16E.

[130] CX 12F.

[131] RX 16F.

[132] CX 192B; RX's 16E–F.

[133] CX's 12A–15Z–21, 139A-D, 140A–Z–15, 148A-C.

growth rate than the U.S. paper market generally or the overall forms industry.[134] WT also knew the U.S. CCP market was growing faster than markets in other geographic areas.[135]

67. That there were high profits to be made in the U.S. CCP market was also apparent to WT in the late 1970's.[136] **[45]**

68. WT planners also knew that throughout the 1970's, the carbonless industry had experienced periods of shortage and by 1981 new capacity would be needed.[137]

69. WT recognized that the U.S. CCP market had a limited number of competitors and high barriers which for all practical purposes insulated the industry from entry by all except Appleton licensees.[138]

70. The opportunities in the U.S. CCP market clearly aroused the interest of WT planners to the point that just prior to the Appleton acquisition WT took a preliminary step toward independent entry. This action occurred during the negotiations between WT and NCR over the 1972 license which was scheduled to be terminated in 1980 unless an extension was agreed upon in 1978. By the terms of this license, WT could not manufacture or sell in the U.S. CCP manufactured pursuant to the NCR technology. On May 19, 1977, WT informed Appleton that it **[46]** intended to terminate the license on July 1, 1980, but noted that both parties had agreed to continue a dialogue about extending the existing arrangement.[139] On September 7, 1977, WT officials proposed that the license be extended for five years, but with the addition of an amendment allowing for WT's use of any and all NCR technoogy in the manufacture and sale of CCP worldwide including the U.S. after June 30, 1980.[140] On September 12, 1977, NCR officials agreed to this proposal on payment of a 1% royalty.[141] WT replied that it would pay no more than 1/2%.[142] At about the same time, however, WT executives became aware of the possible

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[134] CX's 12K-L, 18"O", 47I, 53B, 58A-"O", 96A, 128B, 209D, 221K, 257Z-27-Z-28, Z-62; RX's 16E, *591C, F. See also* Best 2790-91, Sheehy 3560. Indeed, B.A.T's acquisition of Appleton was considered "a resounding expression of confidence on the part of one of the world's biggest companies, in the long term future of the whole CCCP business. . . ." CX 14Z-4. For long term projections of the continued growth of CCP by Appleton and others *see* CX's 4A, 10D, 20A, 21V, *31"O"*, 38Z-32-Z-33, 121X, 191D, 340N, 530D, 533Q-R, T.

[135] CX's 36H, 82V. There is some evidence that WT planners were attracted to the U.S. CCP market as a base for sales of other WT products in the U.S. and as a site where lower grade CCP could be made for shipment to Europe. CX's *29V*, 47F, 49C, 82"O", 128D, 137B, 151A. 226B, 229B, 257Z-95-Z-96.

[136] RX's 16E, I.

[137] CX's 16Z-36, Z-39, 98A. *See* CX's 83D-E, U for a 1975 projection by WT planners of over-capacity until 1980 at which time Appleton and Mead might not be able to meet the market demands of the 1980's. *See also* CX 154C for a similar Appleton projection for 1980-1981. While the recent deep recession has put the CCP industry into an over-capacity position (Reeves 807, 816, P.C. Smith 963-64, Kershaw 1218-19, Hangen 1843; CX 56A; RX's 496Z-72, *524A*), respondents themselves do not regard the transient risk of economic downturn or temporary overcapacity as deterrents to expansion. CX's *48F, 207G-H*, 209E; RX's *591J, Z-8. See also* CX's 330B, 419"O".

[138] Sheehy 3561; CX 142J; *see also* CX *48D*.

[139] RX's 232A-B.

[140] CX's 117A-B. This proposal did not originate in September 1977. As early as February 1976, WT executives had planned to ask for "Freedom of sale anywhere in the world" as part of the license renegotiations. CX 118B.

[141] CX 117B.

[142] RX 234B.

availability of Appleton through acquisition,[143] and on October 10, 1977, the chairman and managing director of WT passed on to other key executives the following cautionary note:

> . . . it would be desirable for WT *not* to have negotiated U.S. manufacturing or selling rights under a new agreement with NCR before acquisition, since this would weaken the argument that the acquisition of Appleton is [47] WT's only practicable entry into the U.S. market.[144]

After this warning was received, the idea of amending the license to allow for independent entry was not pursued further.[145] Eventually, the question of the license renewal became moot when the acquisition agreement was reached on May 5, 1978.

71. During the hearings there was testimony from WT and Appleton officials that the September 7, 1977, proposal to amend the license to allow for WT entry into the U.S. market was intended by WT and perceived by Appleton as a bargaining strategem aimed at reducing royalties.[146] There are no contemporaneous documents, however, at either WT or Appleton which dismiss the WT demand for access to the U.S. market as a ploy. To the contrary, Thomas Busch, the vice president of Appleton at the time said without reservation that "Wiggins Teape would like access to the North America continent but did not give details."[147]

WT's Ability To Overcome Barriers And Disincentives To Entry Into The U.S. CCP Market

72. Notwithstanding the attractiveness of the profits and the growth potential of the U.S. market, there were in 1978 a [48] number of conditions which made entry difficult. As Appleton's executive vice president for development and research observed—

> In operating terms the complexity of each aspect of the business and their combined strength amounts to a formidable deterrent to new entrants.[148]

The seriousness of the barriers and whether WT was uniquely situated to overcome such disincentives to entry are treated in Findings 73–85.

73. By 1972, the key NCR CCP patents covering the encapsulation

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[143] As Chairman Best of WT put it: "the renegotiation of the 1972 agreement was, in fact, overtaken by the opportunities which we took during the negotiations to open up the subject with NCR of their potential interest in selling [Appleton]. . . ." CX 257Z–27.

[144] CX 47H.

[145] Cummings 5709.

[146] Hangen 1945, Best 2552, 2689–90, 2697.

[147] CX 114B. *See also* CX 120A.

[148] CX 48D.

process had expired.[149] Nevertheless, there still existed at least an appearance of a patent maze which might deter entry.[150] A WT planning officer made the following assessment of the patent problem just months after the Appleton acquisition:

> We recognize their [Appleton's] strength lies in the sheer volume of patents they hold: of the order of 150 representing 50% of CP related products in the USA, for instance; with new ones being continually added; for example, this number has held constant since 1974 as old patents have expired and new ones have been obtained; even though many appear to offer dubious protection, they all [49] add up to an inhibiting influence on the rate at which CP technology can spread in terms of new entrants to the CP business and the general difficulties existing producers have to contend with in developing new materials and processes that are free of patent infringement.[151]

74. If the patent threat was composed of a large measure of illusion and some substance, the same cannot be said of mastery of the technology and know-how of CCP production.[152] The record proof is overwhelming that the technical problems inherent in CCP manufacture—especially the microencapsulation and coating of color formers—requires years of extraordinary effort with no guarantee that at the end of this long lead-time a quality product will be produced at an acceptable cost.[153] **[50]**

75. WT's confidence in its CCP technology was boundless. It conceded little to Appleton's expertise, and it believed that it shared equally with Appleton the claim to being "the world's leading technologists in this [CCP] field."[154]

76. WT had available at least two possible ways of applying its vast CCP experience and thereby overcoming the technological and know-how barrier as well as whatever patent problems may have existed. First, it could have obtained from NCR an extension of the licensing agreement which could have given WT the right to use in the U.S. Appleton patents and all of Appleton's unpatented know-how relating to the manufacture of a resin-based CCP.[155]

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[149] Hangen 1814; CX's 12X-Y.

[150] *See* P.C. Smith 1064–65, Langlais 1130.

[151] CX 343A. A 1977 assessment by H.F. Rance concluded that Appleton had already exploited its patent position far beyond its legal life, and that by 1980 patents would not be a major deterrent to entry. CX 194E.

[152] To illustrate the complexity of the CCP technology, two Japanese CCP producers, Jujo and Mitsubishi, who were not required to take out patent licenses (NCR did not have patent protection in Japan) nevertheless did so in order to acquire Appleton know-how. Cummings 5427–28. *See also* CX's 12Z–11–Z–12 for evidence that a license for questionable patents may be taken in order to meet the real need for know-how.

[153] International Paper, which eventually abandoned its efforts to produce CCP, spent five years attempting to develop a CF formulation, the aspect of CCP technology which is easiest to master. It then estimated that even with a viable CF formulation, it would take four to six years more to master the remaining technology but that additional technical problems could mean an even longer lead time. CX's *66Z–26, Z–28.* Champion failed to produce an acceptable CCP despite the expenditure of $8 million to $10 million on development. CX 101A. It took Moore ten years to perfect its capsule technology at a development cost of $3 million per year. *See* Finding 41 and CX's 14F, 257L-N.

[154] CX 128B. *See also* CX's 105B, 114A-D, 116D, 257N, 258Q; RX's 174A-K.

[155] *See* CX 105 (Appendix A at W). A proper inference to be drawn from the offer of this license (*see* Finding 70), is that by 1977, NCR's evaluation of its own and WT's technology had led to the conclusion that WT could not be

(footnote cont'd)

Respondents' argument that entry into the U.S. with a resin-based technology would have placed WT in the position of a raw [51] beginner, feeling its way with an unfamiliar product, is not supported by the record. It is inconceivable that the conversion from clay to resin could constitute an entry barrier to the combined expertise of the two leading CCP technologists whose 30 year open-door technological exchange would have continued under NCR's proffer of a license to manufacture in the U.S.[156] As it happens, the difference between clay-based and resin-based applies mainly to the CF coating, the easier aspect of CCP technology.[157] With respect to the CB coating, the technology of clay-based and resin-based starts from a common base,[158] and historically the switch from clay to resin has been well within the technological capability of experienced CCP firms.[159] [52]

77. As an alternative to a licensing agreement with Appleton, WT could have attempted to use its own independent "Idem" technology which was grounded in a clay-based CF reactant. Beginning in the early 1970's, the technology of the two firms diverged (Appleton switched to resin-based CF, while WT continued with clay-based),[160] and the British firm began to develop technological independence. By 1978, WT was convinced that its independent technology had progressed to the point that the "Idem" brand of CCP could be produced in 1980 without infringing NCR patents.[161] Appleton officials concurred in this agreement of WT's capability.[162] [53]

78. It is not clear, however, that a clay-based "Idem" could be made in a cost-effective manner and sold profitably in the U.S. While WT's "Idem" is superior in quality and less vulnerable to attacks on toxicological, ecological, and environmental grounds than Appleton's

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kept out of the U.S. through the assertion of a dubious patent block, and that the most that NCR could reasonably expect was the payment of a 1% royalty. *See* Hangen 1885 for a similar line of reasoning which preceded the grant of a license to Mead in 1971.

[156] For evidence of the practically unlimited access which WT had to Appleton technology *see* CX's 47B, 105 (Appendix A at M, W), 255S-T, 257S-T; RX's 6A-7D, 12A-P.

[157] P.C. Smith 910–11, Langlais 1124, 1139–40, 1156, Hangen 2269, Hummell 4041, Brogee 4746; CX's 105B, 255Z–3, 492C. There is also evidence that resin CF is easier to master than clay CF. *See* Langlais 1158, 1167.

[158] Hangen 2062–63, Best 2714. WT's development of an independent capsule technology began with the acquisition of NCR's Borehamwood, England plant (Best 2711–12) which essentially duplicated Appleton's own Dayton capsule plant. Hangen 2353.

[159] *See* Langlais 1153. Appleton and Mead switched from clay to resin. Mitsubishi and Jujo, Appleton's Japanese licensees, produce both a clay and a resin CCP. Langlais 1129, Hangen 2066, Cummings 5429.

[160] WT had not moved to a resin system because of the cost of importing resin and the persistent shortage of raw materials. CX's 12Z–9–Z–10.

[161] CX's 36B, 82L-M, 116D, 257S-T, Z–50; RX's 37D, 75B. A prepared-for-litigation memorandum (RX *402A–Z–164* by a patent attorney, Peter Smolka, is simply a lawyer's attempt to dredge up every conceivable patent problem that might face an entrant with a clay-based product. The Smolka memorandum is far removed from every-day business realities in which patent lawyers and technicians find ways to alter formulations as they skirt specific patents and avoid spurious infringement suits (*See* Smolka 5851, 5896–5900, 5908, 5910–11; CX's 12Z–11–Z–12; *see also* Hangen 1921 for evidence that Moore was able to produce a clay-based CCP without infringing anyone's patents). Moreover, Appleton itself seems to be quite prepared to settle patent claims against alleged infringers who might have claims of their own to assert against Appleton (*see* Hangen 1981–83), a policy which would be pertinent in the case of WT since it has accumulated a portfolio of U.S. patents. CX's *274Z–16–Z–17*(¶46); *see also* CX 200A.

[162] CX's 254Z-47, 255X.

"NCR" paper,[163] it is a superiority which may only be obtainable at a higher cost than the U.S. market is willing to pay.[164] Respondents also point to the evidence of some buyer reluctance to accept a clay-based product in the U.S.[165] In making this argument, respondents of course nicely overlook their alleged apprehension over the dire consequences for Appleton (or WT as a hypothetical independent entrant) resulting from Moore's integration into [54] manufacturing, although Moore's integration happens to be with a clay-based product.[166] In any event, the issue of clay versus resin need not be resolved here since complaint counsel's expert conceded that entry with "Idem" as it is formulated in the U.K. would not have been competitive,[167] and the economic model of entry, which is at the heart of complaint counsel's case, is premised on WT entry with a resin-based CF subject to the payment of a 1% royalty to Appleton.

79. Entry into the U.S. CCP market not only requires a substantial capital outlay in absolute terms, but the outlay is at considerable risk depending upon the stage of the potential entrant's technological advancement. Champion is reported to have spent between $8 million and $10 million on CCP research and development alone with nothing but losses to show for the effort. In addition to the continuing costs associated with research and development, the production of CCP requires extensive physical facilities—emulsion plant, coaters, converting equipment, warehouse facilities—which were estimated to approximate $50 million in 1979 for a facility capable of producing about 60,000 tons of CCP. These capital outlays are at risk, too, since they represent sunk costs that [55] cannot easily be recovered because the equipment is so specialized it cannot be converted economically to other uses.[168]

80. B.A.T's financial strength was such that its officials believed that it was probably one of the few paper companies in the world that could afford NCR's $300 million asking price for Appleton. By the same token, the more modest form of entry posited by complaint counsel ($44 million for a greenfield coating plant, *see* Finding 113) was well within the financial reach of many firms.

81. Respondents argue that an important disincentive to indepen-

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[163] Cummings 5408; CX's 13Z-8, 256Z-12-Z-13, 257Z-11-Z-13, 265A.

[164] Best 2405-06, Elliott 3085, 3394-95; CX 14S. *See also* concession of complaint counsel at Tr. 6895-96 ("Idem . . . is apparently not the product that the U.S. buyers are willing to pay more money for. . . .")

[165] This reluctance, however, may not be deeply ingrained since it stems partially from Appleton's own inferior clay-based CCP which was discontinued in 1973 (Roth 1759-60) and partially from the use of Attapulgite clay which has been replaced by Stilton clay from Japan. CX's 12Z-9-Z-10. Given WT's reputation for producing a clay CCP which is superior to Appleton's resin paper, it is reasonable to assume that any existing prejudice against clay-based would not have been an insurmountable barrier. As for the incompatiblity of clay and resin, this can hardly amount to a serious deterrent since even the resin CCP's of different U.S. manufacturers are not intermixed as a rule. W. Smith 474, Hangen 1870, Hummell 4014-17, Clampitt 4215, Eichner 4270-71.

[166] Langlais 1124.

[167] Horowitz 1607-08.

[168] *See* Findings 25, 113; CX 101A.

dent entry was the prospect of in-house coating by forms printers. Respondents, however, have not explained how the seriousness of this threat in 1978 would have been a disincentive for an investment of less than $50 million (that is, for de novo entry as assumed in complaint counsel's economic models) but did not discourage the expenditure of $300 million to purchase Appleton. Moreover, the record plainly reveals that in 1977 and later, after addressing the issue of in-house coating, Appleton and WT officials were sanguine about the prospects of the CCP manufacturers despite the threat of the [56] loss of some of Moore's business. Respondents' managers were informed that because of scale considerations and developmental costs, in-house coating would be confined essentially to Moore, and Moore's conversion to CCP from its historic attachment to OTC (even if it were to be accomplished through in-house coating) should be encouraged since it would boost CCP sales generally.[169]

82. Respondents also argue that any de novo entrant in 1978 would have been discouraged by the threat to CCP growth posed by such technological advances as non-impact printers, "intelligent" copiers, computer output on microfilm, and electronic information storage which eliminate entirely the use of multi-part business forms. This alleged threat to CCP from technological advances was assessed by Appleton itself in 1976 and later and was largely dismissed as management predicted [57] vigorous growth for the industry. In fact, Appleton management believed that technological innovations would have no appreciable impact on CCP, or may well prove to be a positive factor in increasing growth,[170] a view shared by WT advisers and planners.[171]

83. A potential entrant into the U.S. CCP market would have to come to grips with the question of whether to have an integrated paper supply. How this issue impacts on manufacturing costs and profits of a new entrant is treated at length in Findings 103–110. Even apart from the cost factor, some CCP customers prefer to deal with a manufacturer who has an assured (namely, its own) source of paper.[172] The record indicates, however, that assured sources of paper

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[169] CX's 12Z–23, 14Z–11–Z–12, 39D, 47I, *48E*, 50G, 209E. For evidence of Moore's heavy investment in OTC *see* CX's 140K-L. Respondents' assessment of the significance of Moore's entry was shared by Nashua (Kershaw 1238) but a 1977 report to Mead by the Boston Consulting Group predicted a low rate of growth due to backward integration. RX 496"O". *But see* RX *591I* for respondents' 1981 statement that "Feasibility of further inroads by forms manufacturers may be questionable." Moore still considers itself an important CCP customer since its "production of carbonless paper is not adequate to meet its requirements for carbonless paper now or in the near future." RX *354H*. In 1978, Moore's future projections showed that it will have to purchase 65% of its carbonless requirements. RX *354H*.

[170] CX's 20D, *29Z–9*, 38Z–32–Z–33, 91Z-Z–2, 156A, 255Z–36, 532D, 533L.

[171] Sheehy 3560; CX's 12Z-33-Z-35, 13Z-13, 14Z-18, 15Z-20, 18R, 82L. *See also* W. Smith 483–87 for evidence that CCP growth will continue as a result of such applications as minicomputers and distributed data processing.

[172] Reeves 719–20, Roth 1756–57, Clampitt 4181, Mustari 4365–66, Dimitriou 4517, Pohly 4616. *But see* McMullen 366, W. Smith 473–74, 600.

are readily available.[173] [58]

84. Putting together a paper merchant distribution system from scratch would have been a major problem for a new entrant. Because of the high cost of inventory, established merchants are generally not receptive to the notion of carrying more than one brand of CCP,[174] and they may be reluctant to switch to a new entrant even if a discount is offered.[175] Respondents make no claim, however, that Appleton and Mead have tied up every paper merchant. Moreover, considering the importance and profitability of CCP, as well as the uneven reputation for quality of some existing manufacturers, WT could have broken into the market by distributing through merchants who are not opposed to "dual-lining," or who have indicated a willingness to switch suppliers because of quality concerns, or who either had not carried CCP previously or had carried the product once before and had subsequently discontinued distribution.[176] [59] Whether such a group of merchants would have grown into a viable distribution network would have depended upon WT's success in producing a quality product and marketing that product aggressively, attributes which WT had demonstrated convincingly in Europe and elsewhere.[177] Similarly, while it would not have been easy to take the business of the forms printers away from the entrenched CCP manufacturers,[178] there is evidence that large CCP users would welcome a new manufacturer who could offer a quality product and serve as a reliable and geographically covenient alternative source of supply.[179] If the new entrant sold a quality product below market price, this would be an added attraction,[180] *but see* Finding 116 for the feasibility of entry into this tight oligopoly by use of price-cutting. [60]

85. Much is made by respondents about WT's alleged lack of technical personnel for U.S. entry.[181] While the technology is elusive, there is no proof of a shortage of technicians. To the contrary, the record indicates a ready pool of personnel which could be pulled together from former WT technicians who were dropped as an economy meas-

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[173] CX's 21Z-5, *48J*, 186H-I, 209J, 330D. *See also* P.C. Smith 1061.

[174] P.C. Smith 1101, Kershaw 1249–50, Ramey 3831, Pohly 4622–23, 4628–29, Anderson 4968-69; CX 278J; RX *313B*. Some measure of this reluctance may itself be a function of the current market structure in which a merchant has much to lose if the dominant firm is alienated. Thus, the fact that one would have to "shoot" long-time Appleton loyalist Clampitt before he would even consider trying a new line (Clampitt 4181) suggests that the eagerness to please an essential supplier has supplanted a reasoned concern for quality and price competition.

[175] Clampitt 4184, Pohly 4630, Anderson 5031-32.

[176] For evidence of the availability of merchants for one or more of these reasons *see* W. Smith 472, 591–92, P.C. Smith 1057–58, 1104–05, Kershaw 1209–11, Hangen 2219, 2223, 2244, Clampitt 4206–07, Pohly 4616–17, Anderson 5006; CX's 203, 259Z–16–Z–17, 279B, 284B-C, 286, 288A-B, E-F, 307B, 309C-D, 314B, 340R-S; RX's 480A-Z–103.

[177] Best 2730–32, Kershaw 1242; CX's 47C, 136A, 257Z–35-Z–36.

[178] Reeves 757–58, Roth 1748–49, Hummell 3994, Brogee 4675.

[179] W. Smith 470–72, 591–92, 596, Reeves 687, 814, Mustari 4469; CX's 254Z–31–32; RX's 480B,S, Z–5, Z-9–Z-10, Z–12, Z–80, Z–84.

[180] W. Smith 470–473, Reeves 687, 712–16, Kershaw 1324, Roth 1747–48, Ramey 3852, Eichner 4265–66; RPXF, Vol. II at 217.

[181] Best 2482-83.

ure, existing 3M personnel who are underutilized, and Mead or Appleton employees who might want to get in on the ground floor of a new CCP operation.[182]

Other Alleged Potential Entrants

86. It is manifest that mastery of the coating technology has operated in the past to limit the field of potential entrants into the U.S. CCP market. As Chairman Best of WT put it "only the NCR licensees had made real progress on the world scene (save possibly Fuji with Sarrio/DRG). There had to be a reason."[183] The obvious reason is that a licensing [61] arrangement with NCR gives the licensee the experience, the technological capability, and the know-how which are required before entry can even be contemplated. That a prior relationship with Appleton is a clear advantage in overcoming the technological entry barrier is illustrated by the fact that of the U.S. paper companies, only Mead, after 17 years of experience with the process and an intimate working relationship with Appleton, was able to achieve a clear success.[184] The importance of the relationship with Appleton is further demonstrated by the history of Boise, a major paper company and a licensee of Nashua. Boise's success after nearly five years of development is by no means assured as it continues to be plagued by technological difficulties.[185] Champion, a large and well-respected paper company, was a failure because of technological problems.[186]

Both Crown Zellerbach and International Paper Company, giants in the paper industry, considered the possiblity of entering the U.S. CCP market and eventually rejected it. Both [62] have excellent distribution networks, are fully integrated, and have extensive coating experience. Crown worked at CCP development over a ten year period before deciding that technology barriers were too difficult for it to overcome.[187] International Paper has made an "irreversible" decision not to enter the CCP field.[188] International Paper believed that development of technology from scratch would take many years and carried with it a high risk of patent infringement and no guarantee of a successful product.[189] The fact that Great Northern Nekoosa, Frazer, James River Corp. and Georgia-Pacific Corp. coat CF for Moore and Nashua does not show that they are even close to perfecting the infinitely more difficult CB technology.[190] Indeed, the President of Appleton acknowledges that paper companies are not likely potential entrants.[191]

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[182] P.C. Smith 1063, Langlais 1173, Ramey 3833-34. Also, the exit of Champion left a group of CCP technicians who might have welcomed an opportunity to take another crack at the problems of CCP production; this time, however, with one of the world's best CCP technologists.

[183] CX 142J. *See also* Best 2478. Thomas Busch, Appleton's Executive Vice President for research and development wrote in 1979: "The characteritics of the carbonless business worldwide are such that it offers an opportunity for growth to relatively few paper companies. By paper making standards, the number of competitors is small." CX 48D.

[184] RX 283P. *See also* CX 254Z-33.

[185] *See* Finding 40 and CX 212C.

[186] *See* Finding 39.

[187] CX's 199A, 254Z-54.

[188] CX 208A.

87. Appleton's Japanese CCP licensees—Jujo and Mitsubishi—are legally barred by the terms of a 1977 [63] licensing agreement from entering the U.S. at least until 1985.[192]

88. Fuji, another Japanese producer, manufactures CCP pursuant to an agreement with Mead, which provides that Mead has the exclusive right to manufacture and sell CCP in the U.S. using the Fuji technology.[193]

89. The status of the fourth Japanese producer, Kanzaki, is unclear. Although there is evidence that this firm is barred from selling in the U.S. because it licenses the Fuji technology and is subject to the Fuji-Mead restriction,[194] it has sent samples of CCP to U.S. firms.[195] The record, however, [64] contains no proof of actual Kanzaki sales of CCP in the U.S.[196]

90. As shown in Table 4 below, at the time of the Appleton acquisition, apart from WT, all other European producers had achieved limited success even in their own home market.

Table 4
Share of European Market By European Producers and Exporters in 1977

European Producers	%
WT	45.4
Sarrio	6.3
DRG	5.9
Feldmuhle	4.7
Zanders	3.8
Reed	3.4
Binda	3.0
3M	2.8
Pelikan	1.8

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[189] CX *66Z–28.*

[190] Langlais 1139–40.

[191] CX 254Z–54.

[192] Hangen 1894–95, Best 2663–64, Cummings 5435–37; CX's 257Z–88–Z–89. There is nothing in the record that suggests that in 1985 the Japanese firms will request, or more importantly that respondents will grant, the boon which WT was given in 1977—an opportunity to enter the U.S. with Appleton technology. *See* CX 255Z–7–Z–8. There is evidence that the Japanese firms produce an excellent resin-based product using advanced coating techniques, but whether they could enter without a licence is doubtful since in 1977 Fuji and Mitsubishi, unlike WT, decided to renew their licenses thus indicating a continued dependence on Appleton. *See* CX's 54B, 59C, 105 (Appendix A at L), 112C, 120B, 258Z–29, Z–36–Z–37, 272L.

[193] CX's *341A-Z–19;* RX's *633A–35S.*

[194] P.C. Smith 1071.

[195] Reeves 850-51, Mustari 4378, Anderson 4965–66; RX's 194A-B.

[196] *See* CX 2591.

European Producers	%
Ahlstrom	0.8
Imports from Japan	13.9
Imports from U.S.	6.6
Others	1.6

Source: CX 54D[197]

91. There is no substance to respondents' argument that entry potential should be afforded to firms listed in Table 4 or [65] to other European producers who have not even registered a discernible market share. Sarrio and DRG, WT's principal European competitors at the time of the Appleton acquisition, are apparently barred from entry because they are Fuji licensees and subject to the Fuji-Mead entry restriction into the U.S.[198] As for the others, the record suggests sound reasons for their modest European accomplishments and there is nothing in the record to indicate that U.S. entry would serve to cure the defects of these insignificant producers. To illustrate, Pelikan does not have a research or development program.[199] Feldmuhle purchases a technologically unsophisticated CB emulsion from BASF.[200] And Kores, another firm nominated by respondents as a potential entrant, made CCP with a chemical process which was described by a visiting U.S. forms printer as requiring "an explosion-proof environment, and our printing plants are no place to have that kind of technology, so I had to rule that out right away because of that."[201] [66]

92. There is no reliable evidence that Moore or any other business form printer has shown any interest in producing CCP for the U.S. resale market.[202]

93. There is no reliable evidence that chemical companies have mastered the technology of CCP production or are capable of doing so.[203]

Temporal Factors

94. Given its already established high level of technological competence, it is reasonable to infer that had B.A.T not acquired Appleton, and assuming further that de novo entry was economically attractive, independent entry could have been accomplished by WT between 1980 and 1982. On June 1, 1977, B.A.T notified NCR of its intention to terminate the licensing agreement which meant that this restraint on WT's entry after July 1, 1980, would have been removed.[204] That July 1, 1980, is reasonable as the target date for actual entry draws

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[197] In 1981, European market shares were: WT 39%, Jujo 9%, Feldmuhle 8%. Cummings 5477–78.

[198] CX's 16Z–50, 257Z–88, 258U; RX's 633–35.

[199] CX 258Z–13.

[200] CX 257Z–86.

[201] Roth 1702. *See also* CX 257Z–87.

[202] *See* Finding 42.

[203] *See* Langlais 1145, 1149–50.

[204] CX's 258Z–59–Z–60.

additional support from WT's request of NCR (which was granted but not pursued further because of the impending Appleton [67] acquisition) that instead of terminating the license, it be allowed to continue the NCR license but with the right to manufacture and sell in the U.S. beginning on July 1,1980.[205]

95. Not only is the date of entry reasonably predictable (that is, assuming it was economically feasible) but successful[206] entry at any point in the forseeable future would be competitively beneficial, given the tight oligopolistic structure of the U.S. CCP market and the unlikelihood that CCP [68] will soon become obsolete as a result of new technologies. Since the early 1970's and the entry of Mead, the CCP industry has assumed its present shape, and the long-range projections of Appleton, WT, and others indicate that it is likely to remain a highly concentrated market with few potential entrants on the horizon.[207]

Pro-Competitive Impact Of Alternative Entry

96. Appleton itself recognized that new competition from abroad "would have to be met competitively on quality and price in the marketplace."[208] Similarly, B.A.T knew that Appleton's [69] ability to impose price leadership and "stability" on the CCP market was a function of its 50% market share, and that this "effective influence" could be eroded by any significant loss of market share.[209] Clearly, successful new entry would not only increase consumer choice but would make collusive behavior by Mead and Appleton less likely.[210]

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[205] Finding 70. While July 1, 1980, is a reasonable target date, respondents' records suggest that it would take two to four years to plan and construct a new coating operation. CX's *159A, 241H;* RX *121Z–45.* Chairman Best's estimate of six years (*i.e.*, 1978 to 1984, *see* Best 2500–11) was done on the spur-of-the-moment for litigation and is the product of a presumed lack of information which would be truly remarkable for any firm which has been in the CCP business for even a short period of time and for a firm like WT, which has had a nearly 30-year relationship with Appleton and had developed intimate knowledge of U.S. costs and requirements (*see, e.g.*, CX's 12A–15Z–21, 47B, *171A-Z–8;* RX's 459A–463F, 592A-F), Best's estimate can only be viewed as an exaggeration beyond belief.

[206] The issue of successful entry presents a temporal element of its own because of the interval between the date of the evidence showing the violation, and the time when an entry decision would have to be made should divestiture be ordered. While every antitrust case must deal with the problem of staleness (and the Commission has warned against any tendencies to "up-date" already too voluminous records, *see Koppers Company, Inc.*, 77 F.T.C. 1675, 1677 n. 4 (1970)), the time factor is somewhat aggravated here because of the nature of government's case which rests essentially on an economic model of entry reflecting 1978 data. These data may or may not be valid for the purpose of determining whether a violation occurred— *i.e.*, a violation grounded on what B.A.T would have done in 1978 had the acquisition been blocked. But a divestiture of Appleton can be justified now only if economic modeling undertaken from a 1978 perspective remains presently valid, at least to the extent that the major factual assumptions respecting volume, prices, and costs have not changed so that independent entry which may have been feasible in 1978 is still feasible today. There is evidence that at least one of the components of complaint counsel's models should be adjusted to reflect more recent cost experience (*see* Finding 114) and there was some testimony that in the recent state of over-capacity, a new entrant may have difficulty reaching the volume levels projected in complaint counsel's models. *See* Reeves 816, Ramey 3824. The lesson to be drawn from all this is that in actual competition cases grounded on economic models, the case must be tried on a expedited basis, hardly the lodestar followed by either side in this litigation.

[207] CX's 12Z–1–Z–2, Z–37, 32U, 51B, 53A; RX'S 16K-L.

[208] CX 100Q. Even Boise's modest entry on the West Coast has instilled a small element of competition. McMullen 359, Hangen 1904–05, 2213–14; CX's *33Q*, 252C.

[209] RX 16Z–1.

[210] Horowitz 1509–11.

97. WT's own experience demonstrates the pro-competitive impact of new entry. Notwithstanding WT's huge market share in Europe, the entry of Japanese firms since 1972 has instilled price and quality competition.[211]

98. There is no evidence that the B.A.T acquisition of Appleton has had any pro-competitive effects. Undoubtedly, B.A.T brought WT's historic enthusiasm for CCP to the U.S. market at a time when NCR's main interests were focused elsewhere.[212] This enthusiasm has manifested itself in the construction of new facilities and the updating of old.[213] **[70]** But the CCP resale market remains essentially as it was before: Appleton dominates, Mead lags far behind, and no other producer is a significant factor.

The Economic Feasibility Of Alternate Entry By WT

99. Respondents argue that in the so-called "Cummings Study" it had been determined conclusively prior to this litigation that absent the Appleton acquisition, WT had no other means of feasible entry into the U.S. CCP market. The study specifically rejects de novo entry or acquisition of 3M or Nashua. The Cummings Study, however, is not an objective analysis of entry and it proves nothing about the economic feasibility of alternatives, a question which is barely touched on in the report.[214]

Donald Cummings, a WT business strategist, prepared the study early 1977 at the request of Patrick Best, WT chairman. Best admitted that the study was a "brief for the **[71]** acquisition"[215] which was "prepared to basically justify an application to our shareholders of B.A.T and to substantiate that [the Appleton] acquisition strategy."[216] Moreover, the report was prepared with one eye cocked toward U.S. antitrust considerations. The report itself acknowledges that the antitrust laws may be a problem,[217] and Cummings was aware of the antitrust implications of alternate entry before the report was completed.[218]

100. Respondents' officials testified, in substance, that they never seriously considered de novo entry prior to the Appleton acquisi-

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[211] Best 2405, 2406.

[212] CX's 82P-Q, 184Z-37, Z-74-A-75.

[213] Reeves 805-06; CX's 258Z-103-Z-105; RX 397J.

[214] The study can be said to consider the feasibility of de novo entry only if entry is equated with an assurance of a dominant market share (". . . the capacity already installed is such that there is little hope that we could profitably invest in a greenfield site and buy market share on, say, a ten year time horizon in an attempt to wrest C-P market leadership from Appleton; nor is it likely we could oust Mead as number two; at best, therefore, WT would be a poor third with 15% maximum market share after Appleton and Mead's combined 80%." RX 16F).

[215] CX 257Z-62.

[216] CX's 257Z-61-Z-62.

[217] CX 82P.

[218] Cummings 5701-02, 5707-08. *See also* CX 239B.

tion.[219] This testimony cannot be assigned any weight since obviously corporate executives have every incentive to dismiss alternative forms of entry once the government raises a question about an acquisition. Moreover, the testimony is not convincing because during the 1977 license negotiations with NCR some high officials at WT must have thought about the desirability of independent manufacture in the U.S. for why else ask for North American rights. Prior to 1977, there would have been little cause to discuss any form of U.S. [72] entry since WT was effectively barred from doing so by the terms of the licensing agreement.[220] Besides, since the main issue in this case is whether alternative entry was economically feasible, respondents hardly aid their cause by saying that alternative entry was not considered. If the Appleton acquisition were found to be illegal, then presumably B.A.T and WT executives would do what any rational businessman would be expected to do—consider whether there is an economically feasible alternative.

101. Equally inconclusive on the issue of feasibility of entry is the advice of Ramey of 3M who testified that he would have counseled WT not to enter the U.S. CCP market de novo or by toehold.[221] Considering the limited success which 3M has had, the pessimism of this witness is not surprising but hardly apposite to the entry of WT which would have the key advantage 3M lacked—access to the Appleton technology.[222] [73]

Complaint Counsel's Economic Models

102. Complaint counsel's argument in favor of the economic feasibility of alternate entry rests on the models prepared for litigation by their retained expert, Dr. Ira Horowitz, a University of Florida econometrician. These financial models use a discounted cash flow analysis ("DCF")[223] to product internal rates of return ("IRR") that Horowitz believes B.A.T might have earned by greenfield entry had respondents been denied the Appleton acquisition. The base model, CX 260 (in three different scenarios identified as CX's 260A–C) was drawn up by Horowitz from certain stated assumptions and from record facts known or presumably available to B.A.T at the end of 1977 or the beginning of 1978. The model proceeds from the basic premise that

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[219] Best 2717, Elliott 2851–52, Sheehy 3434, Ricketts 3671–72, Cummings 5414.

[220] *See, e.g.*, statement of WT former Chairman Bennett ("North America is the largest world market for paper and WT is excluded from this area for carbonless paper by the terms of the present NCR license." CX 47B).

[221] Ramey 3849.

[222] Several forms printers and the former head of Mead's CCP business would have advised WT to stay out of the U.S. CCP market. This advice is based on predictions about the impact on the industry of in-house coating and technological developments (P.C. Smith 1015–31, Hummell 3994–98, Mustari 4395–97, Brogee 4717–19), "threats" which were discounted by respondents' own executives in 1978 when they predicted long-range growth for the CCP industry. *See* Findings 81–82.

[223] The discounted cash flow is the financial technique for evaluating a long-term project that takes into account the present value of all expected net cash receipts, discounted by the marginal cost of capital. Horowitz 1446–48.

WT would have entered the U.S. market with resin-based CCP (essentially Appleton's technology for which Appleton would be paid on 1% royalty) produced in a non-integrated operation, that is, without an internal source of base paper. All crucial factual assumptions made by Horowitz are discussed in Findings 103–117. [74]

During the defense case, Vera Elliott, a recently retired WT planning officer, gave testimony challenging the Horowitz assumptions and Robert Heitpas, the assistant comptroller of Appleton, prepared models which were designed to show that the results would have been changed drastically if Horowitz had applied different facts. A counterattack on Heitpas' models, which was mounted in rebuttal by David Painter, chief supervising accountant of the Commission's Bureau of Competition, used still other factual premises to revise the basic Horowitz models and to construct alternate scenarios to the Heiptas models. During the surrebuttal case the Painter models were answered by more Heitpas models. In addition, Elliott constructed a separate series of models (discussed in Finding 119) which were based on an entirely different set of facts than the Horowitz-Painter-Heitpas models.

103. That the bottom line of all the models (the IRR's with or without debt) is extremely sensitive to even small differences in the perspectives and assumptions of the advocate who makes the fact selection, can be illustrated by reference to the crucial issue of manufacturing costs (and the related issue of "other expenses") to be assigned to the prospective new entrant. As shown in Table 5 below, the investment decision of the prospective new entrant might well turn on how the manufacturing cost and "other expenses" elements alone are skewed: [75]

Table 5
Effect On IRR's Of Manufacturing Cost Cost And "Other Expenses" Variations

	Selling Price Per Ton	Mfg. Cost Per Ton	"Other Expenses" as % of Net Rev.	IRR w/o Debt	IRR with Debt	Source & Proponent
Model 1	$1232	$ 875	12.5%	14.0%	17.9%	CX 260A (Horowitz)[224]
Model 2	1232	1044	12.5	2.3	0.7	RPXE, Vol. VI at H00144 (Heitpas)[225]
Model 3	1232	974.34	9.5	10.2	12.6	CX's 474A–D, F–H (Painter)[226]
Model 4	1232	998.57	12.5	5.5	5.8	RX 752A (Heitpas)[227] [76]

(footnotes appear on next page)

104. As illustrated in Table 5, the Horowitz-Painter models show manufacturing costs that result in generally favorable IRR's (*but see* Finding 118 for a discussion of respondents' "hurdle rates"), while Heitpas' models inevitably produce costs which would tend to discourage entry). Summarized below (Findings 105–110) are the contentions of both sides and a review of the record evidence on the pivotal issue of manufacturing cost and the related issue of "other expenses".

105. The manufacturing cost used by Horowitz in Model 1 of Table 5—$875 (or 69% of the selling price of $1270—*i.e.*, Appleton's price before a 3% discount)—was derived by extrapolation from Appleton's own experience. While recognizing that Appleton had the facially plausible advantage of an integrated source of base paper, Horowitz reasoned that this benefit would be offset by the hypothetical entrant's use of state-of-the-art technology in its new coating operation. From the presumed trade-off between integration and technology, Horowitz concluded that the new entrant's manufacturing costs would approximate Appleton's—that is, consistent with Appleton's actual experience, which ranged from a low of 65.3% in 1973 to a high of 73.5% in 1980, the new entrant would have a manufacturing cost equal to 69% of its sales revenues.[228] [77]

Apart from the statement of his conclusions, the record is sketchy as to how Horowitz went about quantifying the benefit to Appleton from integration, or how he solved the even more elusive problem of determining how much of that advantage will be neutralized by a technologically advanced new entrant who only engages in coating. While Horowitz's expertise in financial planning and stochastic modeling was unchallenged, his expertise in CCP manufacture is recently

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[224] Horowitz prepared three models. In addition to the results shown in Model 1 of Table 5 (based on Appleton's price of $1270 less a 3% discount), the IRR's without debt were 15.7% without a 3% discount in selling price (CX 260C) and a 7.8% with a 3% discount in selling price and a manufacturing cost of $975. CX 260B.

[225] With or without debt, with price discounts and without discounts, and with various ways of determining cost of manufacturing, Heiptas built over 40 models, all of which show losses or entry-discouraging IRR's. RPXE, Vol. VIII; RX's 714A–E. Model 2 in Table 5 keeps all of Horowitz's assumptions constant except for a variation in manufacturing cost which was calculated as shown in Finding 107 and note 249, *infra*. Most of the other models done by Heitpas introduce sharp departures from the Horowitz models, including the use of proxies (selected sheets and rolls or rolls only) to determine selling price and manufacturing costs, as well as significant changes in projected volume, maintenance capital, start-up costs, and distribution expenses. *See* RPXE, Vols. I–V. The proxies are especially suspect since they eliminate without adequate justification many of the most profitable items in the Appleton line. Heitpas 7399–7402, 7407, 7991–8020, 8054–57; *see* CX's 38D, 323C–D.

[226] The modeling game can be played with endless permutations, to wit: the 10.2% IRR becomes 10.5% with a lower tax rate, 9.8% with straight line depreciation, 10.6% or 10.9% with lower working capital, 12.2% with no price cut, 9.1% with base paper penalty of $105/ton and 13.0% if the new entrant's plant is 5% more efficient than Appleton's plants. CX's 474D–E.

[227] Respondents' variations on the moves reported in note 226, *supra* appear in RX *752A–B* which, in turn, were answered during surrebuttal by CX 557.

[228] Horowitz 1433, 1441–43, 1446, 1471–77, 1490–91, 1498–99, 1583.

acquired and comes about solely from his reading of the record.[229] On the basis of this record, however, there can be no presumption in favor of Horowitz's integration—technology trade-offs or his premise that a non-integrated coating operation is an economically sound choice for a new entrant to make.[230] For not only does the testimony of industry members reject the non-integrated entry mode, but most of the pre-complaint documents which touch on the [78] subject are in accord with this testimony.[231] Moreover, there is no evidence whatsoever that WT investigated the profitability of non-integrated entry or that it had any other basis for assuming its profitability. To the contrary, WT officials believed that their success in the European CCP market was directly related to the integrated nature of their operation.[232]

That integration is an important factor in efficient CCP production is also clearly reflected in the views of International Paper (IP) which studied the possibility of entering the CCP business in 1975–1976. IP concluded that non-integrated CCP facilities could not be cost-competitive. Thus [79] in one study, an IP official stated that "vertical integration, where pulp mill, paper mill, coating and converting are at one location, would produce the most economical product."[233] In another study, IP observed that "Vertical integration is the critical cost factor."[234] IP also noted that "Appleton has been the industry leader in carbonless, but Mead, with full integration and the lowest cost facilities, is rapidly gaining a strong competitive position; 3M and Nashua without control of their base stock supply, will not be competitive in the longer term."[235] IP believed that merely coating CCP was not profitable or only marginally profitable, and predicted that the CCP "business in the future will be served by fully-integrated producers who can control and achieve profits on base stock production."[236] The reason for this was that "fully integrated producers enjoy significant cost advantages resulting from a lower cost of base stock, less handling and packaging and the potential reuse of waste generated."[237] The objective for IP, if it were to acquire Appleton, 3M, or Nashua, would be to "supply their base stock requirements to offset their product marginal profitability;" this would require IP to "integrate [80] their operations into IP as soon as feasible to achieve the economies of integrated paper production and coating facilities."[238]

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[229] *See, e.g.*, Horowitz 1556–58.

[230] Whether or not a new integrated CCP producer could successfully compete against Appleton and Mead has not been definitively resolved in this record. Respondents' evidence relating to an integrated operation shows that adding the cost of a paper machine ($125 million to $150 million) to the Horowitz model (with its CCP volume of 67,000 tons) would have resulted in steady losses. RX's *706–712*. While complaint counsel quarrel with this estimate of the cost of a paper machine (*but see* P.C. Smith 970, Hangen 2052–53, Best 2478–79, Elliott 2874, Hietpas 8438–41, and CX 160N, for higher estimates and RX's 479C–D (¶5) for complaint counsel's concession that "the cost of constructing a fully integrated carbonless paper plant would be approximately $200–250 million. . . ."), it is noteworthy that there is no evidence which shows that even the highly profitable CCP industry would allow for an adequate return on investment in a costly new integrated operation unless it is assumed that a significant volume (at least double the 67,000 tons in the Horowitz-Painter models) could be wrested away from Appleton and Mead. *See, e.g.*, Ricketts 3672–74.

[231] *See* CX's 17I, 52A–D, 91Z–5, 101B, 184A–Z–83; RX's 115"0", 179C, 286A–L, *309L*, *312A–C*, *316A*. While from time to time questions have been raised at Appleton about the advantages of integration (*see, e.g.*, CX's 186H–K, 241H, 330D, 465), complaint counsel's heavy reliance on these incidents is misplaced. Appleton in point of fact *is* substantially integrated, and because complaint counsel's models are based on Appleton's operations (but without integration) the technical problem of determining the value of such integration is not materially advanced by generalized discussions about integration as an abstraction.

[232] Elliott 2867–68.

[233] RX *303I*.

[234] RX *312B*.

[235] RX's *304Z–12*.

Nashua, Mead and 3M share Appleton's and IP's view that paper making capability is important to success in the CCP business. Nashua believes it is at a competitive disadvantage in the CCP business because its "facilities are not vertically integrated causing them to be non-competitive price wise."[239] Mead would not invest money in CCP coating equipment which was not part of a totally integrated facility that included the production of base paper and a substantial proportion of pulp. Not only does integration reduce costs, but according to Mead it also gives the CCP producer better control over the quality of its finished product.[240] 3M's Ramey identified the cause of his company's lack of success in CCP as follows:

> . . . I think that the situation, the nonintegrated producers, namely, Nashua and 3M, are in very low profitability as a direct result of not being fully integrated.[241] [81]
>
> * * * * * * *
>
> . . . we are dependent upon other companies for the base part of the product—the paper—and we have to pay the market price for paper. We do not get that profit on the papermaking. We do not get the profit on the pulp-making, so we are paying one or two companies a profit and then we are trying to make a profit in an industry that really does not have room for, you know, three profit centers, I do not think.[242]

Horowitz's choice of the non-integrated entry mode is especially puzzling for a presumed WT entry since WT's CCP operations in Europe use internally produced paper.[243] WT's commitment to paper making is shown also by its plans for a European "third site" which also contemplated an integrated facility.[244]

106. Even assuming that the integration advantage is not nearly as decisive as the evidence above indicates, it was never explained by Horowitz how the new entrant would overcome even a lesser advantage through technologically advanced coating. For notwithstanding

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[236] RX *308A*.

[237] RX *308F*.

[238] RX *304Z-25*.

[239] RX *312A*. *See also* CX's 101B, 184Z-44-Z-45; RX's 115"O", *309L*, *317A*, *320*; RPX F, Vol. I at 29, 34, Vol. VI at 123.

[240] P.C. Smith 921-22, 1093-94.

[241] Ramey 3481. *See also 316A*.

[242] Ramey 3844-45. See also Ramey 3908-10.

[243] Best 2384.

[244] CX's *160A*, *E*, 268A-B. See also Elliott 2867-68, Ricketts 3675.

Appleton's flawed performance as a paper maker,[245] its coating capability, including the efficiencies [82] traceable to coating on its paper machines, is unsurpassed.[246] And despite the near 30 year relationship with Appleton, WT's European operation has never matched the efficiency of Appleton, or for that matter of Appleton's Japanese licensees.[247] Horowitz made no attempt to address these particular subtleties in his integration—technology trade-off, and his opinion respecting the transferability of Appleton's efficiencies to the new entrant represents little more than an educated guess in an area which requires some precision.

107. Heitpas, totally rejecting the notion of the offset of integration by improved efficiencies, would include in the new entrant's manufacturing costs a substantial base paper penalty. Heitpas reasoned that if Appleton's experience is to be used it is necessary to deduct the benefit which Appleton derives from having about 70% of its base paper produced internally.[248] The various penalties used by Heitpas (all of which produce [83] entry-discouraging IRR's), were developed from Appleton business records existing prior to litigation including Appleton's November 1978, projections of the penalty used in planning for a Harrisburg expansion ($151.37 per ton applied to Model 2 of Table 5)[249] and the actual experience of the Appleton, Wisconsin plant for the year 1977 (a penalty of $113.50[250] per ton, inflated to 1981 values, adjusted to reflect Appleton's level of integration, and used in Model 4 of Table 5).

108. Complaint counsel's answer to the Heitpas base paper penalty calculations was to have Painter modify the Horowitz model by including a penalty, but one that was substantially smaller than any imposed by Heitpas. This was done by first having Painter adopt Appleton's actual 1977 manufacturing costs, thereby raising the manufacturing cost from $875 to $902. Painter then added an $85 base paper penalty, and after applying a yearly inflation factor of 5% and adjusting for a 70% [84] integration level (Appleton's level of

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[245] CX's 38Z-4, 41C, *66Z-30*, 184Z-65; RX's *303Y*, *304Z-5*. Since 1978, Appleton has modified and somewhat improved its paper making capability. CX's *35Z-8-Z-10*; RX's *118Z-49*, *Z-62-65*, *119Z-44*, *Z-59-Z-64*, *120Z-46*, *Z-55-Z-60*.

[246] CX's 3D, *171A-Z-8*, 177A; RX's 38F, *314X*, 460C. Appleton's Harrisburg facility is the most modern coating plant in the world. Heiptas 8112. *See also* Kershaw 1301-03, 1326 for the opinion of a Nashua executive who recognized the importance of back-integration but believed that Appleton's technologically advanced coating and distribution network were even more important advantages which Appleton had over Nashua.

[247] RX's 38F, 41C, 80H, 84F, 459A-L, 460A-R, 592A-F.

[248] Heitpas 7392.

[249] CX 168E; RPXE, Vol. VI at H00142. The Harrisburg CAR (Capital Authorization Request) projected a penalty of $177.04 for base paper acquired on a completely bought-in basis during the period October 1980 to September 1981. Heitpas 7844-45; CX *462C*. To reflect Appleton's anticipated level of integration (projected in Appleton's 1978 long range plan to approximate 85-1/2% in 1981), the $177.04 penalty was multiplied by .855 to reach $151.37. Heitpas 7567-68; CX 168E. Adding this penalty, Heitpas then arrived at a manufacturing cost as a percentage of sales of 82.2% (RPXE, Vol. VI at H00142) which was applied to Horowitz's non-discounted selling price of $1270 ($1232 plus $38) to reach the manufacturing cost of $1044 shown in Model 2 of Table 5.

[250] Derived from RX *750*, an adjusted version of CX *459B*.

integration in 1977), he raised the manufacturing cost from $902 to $974.34 as shown in Model 3 of Table 5. Painter further assumed that if the new entrant is to be charged with a base paper penalty as a non-integrated producer, it must not be charged with Appleton's expenses attributable to base paper production; accordingly, the "other expenses" category was reduced by the 3% reduction from Model 1 which appears in Model 3 of Table 5.[251]

109. Although Table 5 illustrates the extreme sensitivity of the IRR's to changes in the manufacturing cost element alone, the adjustment made by Painter to reach an $85 penalty can hardly be described as a precise calibration commensurate with the delicacy of the issue. It is instead a rough estimate, undefended by Painter as a witness but advanced by complaint counsel as more reasonable than respondents' figure of $113.50. As complaint counsel would have it, the penalty must be less than $113.50 (they ignore the evidence of a much higher base paper penalties which appear in the record)[252] and probably close to $85 because of doubts which were raised during the cross-examination of Heitpas about the way in which the benefit had been calculated in respondents' pre-litigation business [85] records. Even assuming, however, that respondents' business records are somewhat less than totally reliable for establishing the exact amount of the base paper penalty, nowhere do complaint counsel explain how any alleged imperfections in respondents' business records operate either to (1) negate the other record evidence indicative of a substantial handicap for a non-integrated producer, or (2) allow for a reasoned choice between $113.50 and $85 or some other figures, higher or lower, which could spell the difference between attractive and unattractive IRR's for a hypothetical non-integrated entrant. That the record evidence does not compel rejection of the $113.50 figure (or some higher figure) taken from respondents' business records, or acceptance of the $85 figure which Painter put together, may be illustrated by the following points pressed by complaint counsel in their attack on the validity of RX *750*, the source of respondents' $113.50 base paper penalty:

(a) Complaint counsel claim that respondents' business records showing a penalty of $113.50 (RX *750*) may reflect a [86] small and unrepresentative portion of the base paper used by respondents' Appleton, Wisconsin plant, with the result that it may fail to take into account internally produced base paper having significantly higher costs.[253] But all that the record allows on this point is (1) that respondents derived the base penalty in RX *750* from business records (annual gross profit reports) comparing the cost of raw base stock (*i.e.,* base stock which is later used for coating in contrast to the base paper component of CCP which is made on the paper machine) produced by the Locks and Spring paper mills and shipped for coating to respondents' Appleton, Wisconsin plant, with the cost to the same plant of bought-in base;[254] (2) most of the raw internal base stock coated by all Appleton plants was, in fact, produced by the Locks paper mill;[255] (3) there were times when [87] the Locks paper mill was more efficient than the Spring paper mill, at other times the efficiencies were reversed, and most of the time they were roughly equivalent;[256] and (4) RX *750* excludes base papers with respondents virtually never bought on the outside as well as small quantities of base papers which were always bought on the outside for use in specialty CCP applications.[257] How either of these omissions impact on calculation of the new entrant's base paper penalty was not explored on the record.

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[251] CX's 474A.

[252] *See, e.g.*, note 249, *supra*. *See also*CX 504E which shows that in September 1981, a penalty of $184.90 ($857.50 to buy, $672.60 to produce) was projected in connection with a proposal to build a new paper machine and Heitpas 8617–18 which shows a penalty of $183.56 when RX *750*is extended to 1981. If all the assumptions of the Painter adjustment are kept constant (including a 3% reduction in "other expenses"), and the base penalty added to Model 3 of Table 5 is $150 instead of $85 or $113.50, the IRR's become 6.3 without debt and 7.0 with debt. RX *752A*.

(b) Complaint counsel also say that RX *750* gives too much weight to "MCP" (CCP produced by Appleton as a contract coater for Moore) which may have a higher penalty than base paper used in Appleton's production of CCP for resale. There is no claim made that RX *750* inaccurately reflects the base paper cost for "MCP," and if the new entrants' manufacturing costs are to be modeled on the Appleton experience, exclusion of this part of Appleton's experience is not warranted.

(c) According to complaint counsel, the sales value assigned to base paper by respondents for the purpose of calculating the penalty in RX *750* may overstate the price that [88] WT as an entrant would have paid an outside supplier. There is evidence that in 1981, Appleton's Harrisburg plant was able to purchase base from Fraser Paper at a lower price than the Appleton, Wisconsin plant paid for the same paper when purchased from the Brown Company.[258] Complaint counsel argue that in assessing the size of the non-integrated entrant's penalty, the lower prices available from Fraser must be factored in. But complaint counsel has not explained on what basis it can be assumed that the new entrant would be a more perspicacious buyer of base paper than Appleton. Appleton buys from two suppliers because it cannot obtain the full range of colors, widths, weights, and grades from either one.[259] If WT were to make the full range of CCP grades and colors then presumably it, too, would have had to buy from a second supplier. In any event, the price differential between Brown and Fraser was not nearly as sharp nor as persistent as complaint counsel suggest.[260]

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[253] Complaint counsel argue that as Appleton's cost of producing base paper increases this reduces the penalty which is calculated as the difference between cost of bought-in base and cost of internally produced base. By concentrating on Appleton's paper-producing deficiencies, complaint counsel nicely draw attention away from the fact that the new entrant will have to buy paper and compete against *both* Mead and Appleton, Mead having the advantage of superb internal paper making capability while Appleton has the advantages which arise from even mediocre paper making capability when combined with an efficient coating technique. *See* CX 342.

[254] Heitpas 7754–55, 7854, 8299–8302; CX's 323A–Z–10, 482A–"O", 483A–Z–35, 484A–Z–32, 488A–Z–26, 489A–Z–29, 490A–Z–21. Complaint counsel's criticism of the use of the Appleton plant is especially questionable in light of Horowitz's reliance on the same information. Horowitz 1442.

[255] CX's 483E.

[256] CX's 323C, 482C, 483E, 484D, 489D, 491C–E, 519K, 521P, 538"O"–P, 544–47.

[257] Heitpas 7415-16, 7938-39.

[258] CX's 538"O", 539B.

(d) Another possibility raised by complaint counsel is that the base paper penalty calculated by respondents is flawed by reason of failure to take into account freight savings that WT, as a new entrant located close to base paper suppliers, might have over the Appleton, Wisconsin plant. It is fair to [89] assume that WT would have chosen the most advantageous plant location—that is, like Appleton's Harrisburg plant near enough to paper suppliers so as to gain all the freight saving which a Harrisburg enjoys over a Wisconsin plant in the purchase of base paper from Maine paper mills, and yet close to the eastern CCP customers who represent the heart of the market.[261] But strangely enough, complaint counsel totally ignore the fact that respondents' business records project large base paper penalties for their Harrisburg plant.[262]

(e) The quantification of the base paper penalty is not advanced by still other nagging doubts which complaint counsel raise about the reliability of respondents' business records and [90] the penalties reported in RX *750*. For example, complaint counsel point to Appleton's 1977–1980 "Long-Range Plan"[263] and the 1978 "Five Year Plan"[264] which are allegedly at odds with the base penalties in RX *750* because the plans show decreasing reliance on external purchases of base paper in one instance and increasing reliance in another without substantial changes in gross profit margins. Such broad-gauged predictions are of no use whatsoever in determining the size of the penalty which even complaint counsel now concede must be inserted into the entry model.

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[259] Heitpas 7981–82.

[260] *See* CX's 540D, 541N; RX *244I*.

[261] *See* CX 124P. *See also* CX 284B for Appleton statement of the disadvantage "of our multiple manufacturing and shipping locations."

[262] *See* note 249, *supra* and Finding 107. Neither side explored in detail the applicability of the Harrisburg expansion to the entry question. Complaint counsel suggest but have not vigorously pressed the argument that the projections for respondents' Harrisburg expansion (a 14% DCF on the assumption of bought-in base paper, CX 168H *but see* Heitpas 7538–39, 8144–45 for evidence of disappointing actual performance at Harrisburg) may have some bearing on the profitability of the hypothesized new entrant. Although the Harrisburg expansion is similar to the entry model (*i.e.*, both are two coater operations but Harrisburg also performs "finishing" on CCP produced at Appleton's Roaring Spring plant, CX 489Z–11) there are differences: Harrisburg was conceived of as part of the established Appleton operation which had the effect of reducing "other" expenses (Hietpas 7573–75) and adding benefits (immediate access to Appleton's existing demand, long production runs, and spreading of fixed costs over a larger tonnage, Hangen 1841, Heitpas 7585–7601) which do not apply to the new entrant.

[263] RX 117Z–49.

[264] CX *29Z–60*.

(f) Finally, contrary to the argument of complaint counsel, the penalty calculations of RX *750*cannot be rejected (and presumably Painter's figure accepted) because a penalty of $113 indicates a profit on paper making which is much higher than the profits realized by other paper companies. The base paper benefit (which is the source of the base paper penalty in RX *750*) is not a measure of the profits Appleton could earn by selling its base stock. It is instead an assessment of the contribution to Appleton's profits from in-house production measured by the difference between Appleton's cost of manufacturing base stock and the weighted average price of Appleton's purchases of base stock.[265] Thus, while complaint [91] counsel argue that Appleton's base paper benefit is high when compared with the profits of other paper companies, they ignore the fact that Appleton's costs for manufacturing base stock do not include a charge to itself for expenses—such as freight and packaging—that Appleton would incur if it, like other paper companies, actually sold the base stock as a finished product in the open market.

110. Complaint counsel do not maintain that the "other expenses" element of their models in Table 5 has been determined any more precisely than "manufacturing cost." Horowitz's figure (12.5% of net revenue before a 1% reduction for royalty expense) approximates Appleton's actual experience.[266] However, when Painter inserted a base paper penalty into the Horowitz model, he took a 3% reduction—from 12.5% in Model 1 of Table 5 to 9.5% in Model 3—on the grounds that a change from Appleton's integrated operation to the new entrant's non-integrated mode might result in savings in the "other expenses" category. The savings were to flow, for example, from the prospect that the WT finance department officials would not have to check pulp prices, the chief executive of WT would not have to develop long-range plans relating to paper making, the WT engineering department would not have to plan the proper loading of paper [92] machines, and the warehousing expenses attributable to paper making would be eliminated.

Whether any of these predicted savings would approach 3% of net revenue is sheer conjecture. An equally plausible line of speculation might lead to the conclusion that WT as a new entrant may have a different set of "other expenses" which could conceivably exceed 3%. What the record shows on this point is that "other expenses" ("other distribution costs" and "department expenses" in Appleton's financial statements) comprise freight, shipping, finished goods warehousing, operations services, marketing, "R&D," finance, and the expenses of the president's office.[267] The last three—marketing, finance, and the president's office—clearly relate to Appleton's total business, not to specifics such as the manufacture of paper, and these expenses are not likely to be reduced by merely substituting the purchase of paper for in-house production.[268] Insofar as freight and warehousing are concerned, these charges (or at least the bulk of them) relate to the finished CCP product. Whether a roll of CCP is made with internally-produced or purchased base, it still must be coated, and after it is coated, it must still be shipped. Thus it incurs a freight charge and would do so for WT's plant just as [93] it does for Appleton's.[269] And whether coating of CCP takes place on a paper machine (as in the case of Appleton) or off the paper machine (as in the case of the hypothesized unintegrated new entrant) the category called "operations services"—that is, industrial relations, fringe benefits, freight planning and distribution planning—is not likely to change.[270]

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[265] Heitpas 7767.

[266] Horowitz 1434-35, 1480-81.

Furthermore, it is by no means certain that the differences between a non-integrated new entrant and integrated Appleton necessarily favor one over the other with respect to the total amount of "other expenses." For example, instead of checking purchase prices for raw materials related to paper making, the WT finance department would have to check base stock purchase prices.[271] Instead of planning the loading of the paper machines and assisting in the development of standard cost information for paper machines, the WT engineering department would have had to plan the loading of coating machinery and assess its standard costs.[272] The "R&D" component of "other expenses" would still be substantial, especially considering the new entrant's need to adopt a resin-based technology. And presumably, personnel in the office of the new entrant's chief [94] executive would have to plan for the future as carefully as the Appleton planners. Moreover, as a non-integrated new entrant, WT may have to engage in other activities that are not reflected in Appleton's current level of "other expenses." WT would have to recruit and train new personnel, a cost subsumed under "other expenses." WT would have to devote "R&D" resources and manpower to developing new suppliers of raw materials, particularly resin. Finally, in an attempt to gain sales for the new entrant WT might have had to advertise and promote its CCP product much more heavily than Appleton, thereby incurring greater costs in the marketing component of the "other expenses" category.

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[267] CX 183Z-1.

[268] Heitpas 7779-80.

[269] Heitpas 7797-98.

[270] Heitpas 9052.

[271] Heitpas 8604-05.

[272] Heitpas 8330-32, 8604-06.

111. Several other components of the Horowitz models—all largely adopted in the Painter models—involve various degrees of still additional controversy (Findings 112–117).[273] [95]

112. In the Horowitz model WT would be expected to achieve in its first year of U.S. operation (1981) 15% of the projected incremental growth in U.S. CCP sales for the period 1977 to 1981—that is, 15% of the growth from 279,000 tons to 452,000 tons or sales of 26,000 tons by 1981.[274] Thereafter, WT would obtain 15% of the incremental growth each year until 1987 when volume would reach 67,000 tons, the projected capacity. The model then assumes that WT sales would remain constant until [96] 1995, the end of the useful life of the facility.[275] In other words, the Horowitz model assumes that WT would have obtained a 5.8% share of total industry sales in its first year of operation, and that its share would gradually increase to a maximum of 9.0% in 1986.

The Horowitz volume assumptions are reasonable. Since they are based on a percentage of incremental sales only, they do not take into account the possibility that WT could take some business away from

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[273] The base models (CX's 260A-C) cover the period 1977 to 1995. In the first year of actual production (1981) the model appears as follows:

(1) Industry Projected Volume (000 tons)	(2) W.T. Projected Volume (000 tons)	(3) Capital Outlay ($ millions)	(4) Start-Up Costs ($ millions)	(5) Investment Tax Credit ($ millions)
452	26	($ 44 million) for years 1978-80)	1	3.3

(6) Set-Up Distribution Network ($ millions)	(7) Net Price/ Ton ($ actual)	(8) Mfg Cost/ Ton = 875 ($ actual)	(9) New Revenue Less 1% Royalty ($ millions)	(10) Mfg. Cost ($ millions)
($1 million in 1980)	1232	875	31.71	22.75

(11) Other Expenses at 12.5% of NR ($ millions)	(12) Profit Pre-Tax ($ millions)	(13) Post-Tax ($ millions)	(14) Total Working Capital ($ millions)	(15) Additional Working Capital ($ millions)
4.00	3.96	1.98	6.41	6.41

(16) Depreciation Included in Cost and Expenses ($ millions)	(17) Net Cash Flow Without Debt ($ millions)	(18) With Debt = .385 ($ millions)
2.93	1.80	.95

Source: CX 260A.

[274] Horowitz 1420–22. The industry projection comes directly from WT's own 1977 estimates of growth of the U.S. CCP market converted to short tons. CX 82Z–2.

[275] Horowitz 1420–22, 1463–65.

industry leaders. Moreover, the modest total market share projected by Horowitz (5.8% to 9.0%) should be contrasted to estimates made by B.A.T planners who predicted that a share as high as 15% was a possibility for a greenfield operation,[276] and the actual experience of Mead which went from a 15% market share in the first year of independent operations to 25% within seven years.[277] Mead's success, however, is only partially germane to a possible greenfield entry by WT. On the one hand, WT, like Mead, had a long prior history of CCP manufacture (Mead as an NCR contract coater, WT as a contract coater and independent foreign producer) and both were parties to NCR licensing agreements which gave them [97] intimate access to Appleton technology and production know-how. There are, on the other hand, sharp differences between WT and Mead: Mead had 17 years experience in making CCP for the U.S. market, it had an established nation-wide distribution system, and it entered the market at a time when there was only one substantial supplier.[278]

113. The $44 million appearing under "Capitol Outlay" (Column 3 of CX 260 for the years prior to 1981) is the assumed cost over three years for the construction of a non-integrated CCP operation with a capacity of 67,000 tons. Of this total, $42 million is WT's own 1977 estimate for such a plant, while $2 million represents the cost of a capsule plant as estimated by Appleton in connection with a proposed expansion of its Harrisburg facility.[279] There is some evidence that the cost would be slightly higher if state-of-the-art equipment such as "tandem" coaters were used.[280]

114. The start-up costs estimated by Horowitz (Column 4 of CX 260) were $1 million per coater, a figure derived from [98]Appleton's estimate for its proposed Harrisburg expansion.[281] Appleton's estimate, however, has proven to be wrong. Start-up costs at Harrisburg have been $14.9 million spread over nine years, with the bulk of the charge occurring in the early years.[282] In addition, Horowitz did not assess the new facility with a maintenance charge which may amount to as much as $3 million over the life of the project.[283]

115. Since he had no data reflecting the cost of setting up a distribution network (*i.e.*, cost of conducting market studies; recruiting, training, and hiring salesmen; enlisting paper merchants and other initial one-time-only expenses), Horowitz arbitrarily assigned to this func-

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[276] CX 82F.

[277] *See* Finding 49.

[278] P.C. Smith 943-44.

[279] Horowitz 1422-24; CX's 82Z-3, 86.

[280] *See* Horowitz 1573-74, Hangen 2187, 2345.

[281] Horowitz 1424-25; CX's 167H, 168A.

[282] Heitpas 7538-7559; RPXE, Vol. V. at H00128. With start-up expenses reflecting the actual Harrisburg experience and "other expenses" at 12.5, the IRR's in Model 3 of Table 5 become 6.2 without debt and 6.7 with debt. RX *752B*.

[283] Elliott 3042, Hietpas 7531.

tion $1 million (Column 6 of CX 260).[284] This figure does not include costs attributable to ongoing distribution operations which are shown under the "other expenses" heading. Whether such a modest investment in a distribution network would produce the 26,000 [**99**] tons of CCP sales called for in the first year of the Horowitz model is speculative.[285]

116. The net price per ton used by Horowitz (Column 7 of CX 260) was Appleton's actual sales price in 1977 adjusted for a 5% inflation rate, the same inflation factor projected by both WT and Appleton in 1977.[286] Horowitz then followed two different scenarios: in CX 260A and CX 260B, he assumed that WT as a new entrant would sell CCP at 3% less than the projected Appleton prices; in CX 260C, he assumed that WT would enter at the same prices as the projected Appleton prices.[287] On this record, however, it is doubtful that any appreciable volume could be obtained on the basis of a 3% reduction,[288] or that Appleton and Mead would allow any significant market share to be eroded through an unanswered price cut.[289]

117. Horowitz's method of calculating straight-line depreciation was in error. While he correctly added (in Column 16 of the model) $2.93 million each year (a $44 million capital expenditure depreciated over 15 years) he failed to include an [**100**] equivalent amount in manufacturing costs (Column 8 of the model) because of a faulty assumption respecting the applicability of Appleton costs to a new entrant having a far lower volume of production than Appleton.[290] When corrected the IRR's shown in Model 1 of Table 5 are reduced by 1%. Painter sought to regain the 1% by switching to accelerated depreciation. Accelerated depreciation, however, is not used by either Appleton or B.A.T in assessing the profitability of proposed investments.[291]

Respondents' "Hurdle" Rates

118. Painter's adjustment of manufacturing costs and "other expenses" produces an IRR of 10.2% without debt as shown in Model 3 of Table 5. Complaint counsel then argue than an IRR of 10.2% would induce de novo entry since the Appleton acquisition was made on the basis of an estimated discounted cash flow over 15 years of 10.5%.[292] While 10.5% may be adequate inducement for acquiring a relatively

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[284] Horowitz 1427.

[285] *See, e.g.*, Elliott 3049–50.

[286] Horowitz 1417–18, 1428.

[287] Horowitz 1470, 1506.

[288] Ramey 3835, 3853.

[289] Horowitz 1586–87, Kershaw 1320.

[290] Hietpas 7497–7505.

[291] CX's *32Z–74*, 124Q, *169N*, 168B, I; RX's 61E, 62Z–34.

[292] CX 98C, *but see also* CX 137B where B.A.T described the expected return on the Appleton acquisition as "the minimum acceptable" and "not . . . outstandingly attractive." *See also* RX 28.

risk-free, profitable, and dominant [101] firm,[293] there is no evidence that it is equally attractive for a greenfield venture involving considerable uncertainty. The record indicates that B.A.T. has required at least a 15% IRR for a greenfield investment in the paper industry.[294]

Respondents' Greenfield Models

119. The greenfield models prepared by Vera Elliott for respondents' defense case cannot be used any more confidently than the Painter-Horowitz models.[295] The Elliott models (all of which show losses or entry-discouraging IRR's) are unreliable for the following reasons:

(a) *Product mix.* Elliott's models are based on a product mix consisting of just seven items (CB 15# rolls, CB 15# [102] sheets, CFB 17# rolls, CFB 17# sheets, CFB 14# rolls, CF 15# rolls, CF 15# sheets) which were at the low-end of Appleton's rankings calculated on the basis of gross profit as a percentage of sales. Thus Elliott excluded from her model, without adequate explanation, ten products which in 1977 were more profitable than the most profitable item in her product mix.[296]

(b) *Technology.* Elliott proceeded from the premise that WT would not enter the U.S. with any technological innovations which were not already in use by WT's European operations in 1977/1978. This assumption effectively denied the hypothetical entrant such state-of-the-art techniques as tandem coating (except in RX *701*), high solids capsule coating, and CB and CFB coating on the paper machine for the Elliott models which included back-integration into paper making.[297] Elliott's rejection of these advanced processes (all originated [103] by Appleton and available to WT under the license proffered in 1977)[298] seems to be an odd starting point for a planning document, especially in the light of B.A.T's corporate policy of seeking out the most advanced technology for non-paper (*i.e.,* cigarette)[299] expansions, and WT's plans to include new technology in its own European operation.[300] By excluding advanced technologies, the Elliott models may have inflated capital costs (at a higher machine speed even one coater may have met the targeted volume), raw material costs, freight costs, energy costs, production yields, machine downtime, broke (waste), and employee costs.[301]

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[293] Best 2483–84, Sheehy 3432.

[294] RX 758H. For the purpose of determining the attractiveness of an investment, B.A.T looks first to the DCF without debt. Obviously IRR's could be wildly manipulated by changing the equity to debt ratio.

[295] The Elliott greenfield models include RX *277*, (Single Coater for Clay-based CCP), RX *278* (Three Coaters for Clay-based CCP), RX *279* (Two Coaters and Base/CF Machine For Clay-based CCP) RX *542* (Two Coaters and Base/CF Machine For Resin-based CCP) RX's *593, 594* (Two Coaters & Base/CF Machine With Certain Efficiencies Added For Clay-based CCP), RX *701* (Two Coaters For Clay-Based CCP), RX *702* (Two Tandem Coaters For Clay-based CCP). RX *705* is a revised version of RX *279* which corrects Elliott's earlier testimony respecting pulp prices.

[296] CX 483F. This deficiency in the Elliott models, as well as the questionable proxies used in the Heitpas models (*see* note 225, *supra*), suggest that the question of product mix must be carefully resolved in constructing a model of a two coater operation which would not be able to produce the entire range of products turned out by much larger Appleton. The Horowitz-Painter models simply gloss over the entire question as they proceed from the notion that the Appleton experience will simply be replicated by the new entrant.

[297] Elliott 2866–67, 2873, 2941–42, 3076–77, 3179–81, 3210, 3238–39, 6787, 6801–02.

[298] Elliott 3077, 3180, 3235; CX 196F.

[299] Sheehy 3578, 3596–98.

(c) *Performance.* Even apart from the exclusion of new technology, Elliott's handling of the performance of the new entrant's mill in her models is unpersuasive.[302] [104]

(d) *Costs.* Elliott used the capital costs (and the related depreciation costs and interest costs) experienced by WT in 1977 during expansions in Belgium and at its South Wales facility in the U.K. as well as costs used in 1980 for a proposed European expansion (the so-called "third site").[303] There is substantial evidence that some of the capital costs (and related depreciation and interest costs) would have been lower if U.S. costs rather than European costs had been used.[304] Similarly, Elliott's figure for "mill capital" (normal capital expenditures necessary "to keep a paper machine or a paper mill up to scratch")[305] were based on WT's European [105] experience which may not accurately reflect the more relevant U.S. experience.[306] The costs Elliott assigned to base paper[307] raise still other doubts about the usefulness of her models, as do her highly questionable employee costs.[308]

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[300] Elliott 6781–82; CX's 36A–C, 192G, 376D, 377N, *399A–C*, 455A–456C; RXPXG at B320683A, B302733A.

[301] *See* P.C. Smith 916, Elliott 6731, 6734, 6736–38, 6746–47, 6749–50, 6754–57, CX's 405, 439A.

[302] In creating her first set of greenfield models (RX's *277–79*), Elliott used the performance of WT's Belgian operation, hardly an appropriate choice for a hypothetical new U.S. entrant considering: (a) the Belgium mills use a much larger percentage of lightweight base paper (which impacts on speed and broke, CX 14R) than the U.S. entrant (Elliott 3095, 6718); (b) the Belgian mills produce more sheets (which also impacts on broke) than the U.S. entrant (RX *279Z–1*); (c) Belgian production runs are shorter than U.S. runs resulting in increased broke and more downtime (Elliott 3168–70, 6757); and (d) WT's Belgian operation was inefficient (Elliott 3069; CX's *361*, 379, 388F, *389G–"O"*), and even improvements in Belgium efficiency undertaken in 1978 were ignored by Elliott. Elliott 3069–71, 3113–14, 3229–30, 3240–41, 3264–66, 3303–09.

In later models (RX's *593*, *594*), Elliott used the 1980 efficiencies of WT's planned expansion to a planned European "third site," but she did not adopt the advanced technologies described in Finding 119(b).

[303] Elliott 3100, 3104–05, 3107–08, 3110–11. Unaccountably, however, Elliott switches to Appleton's 20% working capital figure instead of WT's 15%. Elliott 3188.

[304] For example, in the Elliott model, the cost per ton of a single coater is $1,114 ($49 million divided by 44,000 tons). RX's *277F,R*. Elliott, herself, in evaluating the Appleton acquisition had indicated that the cost of a U.S. CCP coating plant is $636 per ton. Elliott 7101; *see also* CX 82Z–3.

[305] Elliott 2972–73.

[306] *Compare* Elliott 3320 and CX 375 with Hietpas 8159–62. *See* CX 82Z–8–Z–9 for a mill capital expenditure for all of Appleton of $2 million as contrasted with Elliott's $2.7 million per year for an integrated two-coater operation. *See also* Elliott 3156.

[307] Elliott used 1975 base paper costs inflated by a 12.6% factor instead of actual 1977 costs which were lower. *See* Elliott 6586, 6589–91. In addition, by using Appleton's freight costs (Elliott 2999–3000) she made no allowance for freight saving on shipments to an east coast plant where the new entrant would presumably locate. *See* Elliott 3342.

[308] In her base models, Elliott charges the new entrant with 914 employees, 27 more than WT's proposed European "third site" although the productivity of U.S. workers is greater than their European counterparts, and the U.S. work week and work year is longer. Elliott 3119–23. Elliott also attributed to the new entrant 77 R&D personnel although Appleton uses only 85 in a much larger operation. Elliott 3352.

Other Forms Of Entry

120. As an alternative to Horowitz's base model in which the greenfield entrant coats the CF, CB, and CFB components of CCP, Painter constructed a model (CX's 476A–C, F–H) which has the new entrant buying all of its outside base paper, contracting out for the manufacture of CF and then reselling the CF at no profit, or only selling CB and CFB, under the assumption that the forms printer would buy CF from a paper [106] company.[309] There is no record support for the proposition that CF could be purchased from an outside supplier and resold at a break-even price. Indeed, the experience of Nashua, which does purchase its CF from an outside supplier, is to the contrary. Nashua's actual experience shows that it sustains large losses on its CF sales—nearly 20% in 1981.[310] As a result, Nashua's carbonless division usually operates at a loss. Although Nashua's experience is the best "model" for this hypothesis, respondents tested it further in an economic model based on Nashua's actual costs of purchasing rolls of CF superimposed on Appleton's operating efficiencies. Such a plant projects losses on CF and a low overall IRR of 6%.[311]

121. Complaint counsel also argue that B.A.T could have entered the U.S. CCP market through a joint venture. Although [107] there is a fragment in the record suggesting that WT considered (and rejected) the possibility of such a joint venture with International Paper in 1976,[312] and even allowing that this evidence is entitled to greater weight than the post-complaint testimony of B.A.T officials concerning their general distaste for joint ventures,[313] the economic feasibility of such a project was not established on the record and is entirely speculative.[314]

122. Another alternative advanced by complaint counsel is the pos-

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[309] CX's 476A–C is an "adjustment" of one of the Heitpas base models appearing in RPX E, Vol. I. In addition to the "wash" sale of CF, the model can be had with different inflation rates, various forms of depreciation, several adjustments of "other expenses," a wide choice of financial packages, and altogether in 16 different "scenarios." CX's 476D–E.

[310] RX's *753A–P. See also* RX *317A* ("on roll sales there is not room for a CP base paper manufacturer and then a converter like Nashua on CB and CFB to take two profits and compete with NCR and Mead who are fully integrated").

[311] RX *751J.* CX 556 is complaint counsel's answer with different assumptions about "other expenses," working capital, freight savings, and plant efficiencies. Most of complaint counsel's criticism of respondents' "Nashua Model" (RX *751J*) revolves around endless speculation as to how Nashua treats "other expenses" and calculates "working capital." All that was established on the record is that RX *751J* requires a small adjustment for failure to take into account volume rebates on purchases of CF. CX's 561A–B.

[312] RX's 44A–C.

[313] Best 2536–40, 2584–85, Sheehy 3451–54, Ricketts 3605–06, 3690.

[314] Complaint counsel did not carry out even a rudimentary analysis of the profitability of such a venture. And while respondents' model of a joint venture (RX's *472A–C*) is suspect since it derives from the Elliott models (*see* Finding 119), the attractiveness of a 50/50 joint venture (in which costs and profits are shared equally) cannot be any stronger than the results shown in Table 5. As for a joint venture in which a U.S. paper company would join its paper making capability with WT's coating ability, it was not shown on the record that such a venture would interest WT or that a paper company would willingly share profits with a coater, given the evidence in the record that paper making accounts for as much as two-thirds of the profits derived from CCP production. *See* Hangen 2044, Best 2585.

sibility of WT entry into the U.S. through one of two toehold acquisitions—Nashua or 3M—although there is no evidence whatsoever that B.A.T considered acquiring the CCP [108] assets of either firm.[315] Since neither Nashua or 3M is lacking in financial resources, the relative failure of these firms as CCP producers must be attributed to either lack of an integrated paper supply or an inefficient technology or both.[316] A WT acquisition would not have provided a paper supply; therefore, the base paper penalties which attach to Horowitz's greenfield models would have applied with at least equal force had either unintegrated toehold been acquired. Furthermore, given the importance which the CCP industry assigns to the design of cost efficient plants,[317] it was never explained by complaint counsel why WT would have been attracted to CCP manufacturers who not only lacked paper making capability (the most efficient mode of manufacture), but also were operating coating facilities which had never matched Appleton's quality or Appleton's efficiency. Of course, it is anyone's guess whether 3M's or Nashua's unintegrated coating operations could have been up-graded to the point where they would have returned a profit sufficient to have attracted WT.[318] As it happens, others who have examined the prospect of acquiring [109] Nashua or 3M (both were apparently available from time to time)[319] have rejected the idea, a judgment concurred in by 3M's own management.[320]

123. Still another form of entry advanced by complaint counsel is for WT to license its technology to a U.S. firm. Although there is some evidence that the licensing option was raised,[321] the record indicates that the return would have been too minimal for WT to risk creating a potential new competitor who might be attracted to WT's main market in Europe.[322]

124. Complaint counsel have abandoned the allegation in the complaint that WT could have entered the U.S. CCP market by exporting CCP from Europe.[323] [110]

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[315] *See* Best 2440, Cummings 5414. The Cummings Report, without going into detail, rejected Nashua, 3M, and Boise as too small for WT to build on. Cummings 5414; RX 16G. In addition, Boise and Nashua were thought to be producing CCP under a technology which WT considered to be inferior. RX 16G.

[316] *See* Findings 36, 37, 105. *See also* Best 2727–28, Sheehy 3443–44, Cummings 5266–67.

[317] *See* CX 533Z–21.

[318] There is evidence that both firms have inefficient equipment and plants. Kershaw 1251–52, 1301–02, Ramey 3903. Respondents constructed models for litigation which purport to show that the addition of new machines and coaters to either 3M or Nashua would have produced negative IRR's. Cummings 5311, 5341; RX's *474C, 475C.* These models are extensions of the Elliott models (Cummings 5580–83, 5625–26) and were not relied upon for the reasons stated in Finding 119.

[319] CX's 82"O", 238A. As Kershaw of Nashua put it "I suppose anything is for sale at a price." Kershaw 1334.

[320] Ramey 3812–20. *See also* Kershaw 1315 for a less than enthusiastic endorsement of the attractiveness of Nashua.

[321] CX's 240A, 243, 245, 365, 366; RX's 36E, 37C, M.

[322] Best 2557–58, Sheehy 3448–49, Ricketts 3692–93, Cummings 5355, 5405; RX 37C.

[323] Tr. 3400; RX *479C*(¶10H). All the record evidence indicates that export of CCP from the U.K. to the U.S. is not economically feasible. *See* CX 54A; RX's 79A, *276A-L.*

III

DISCUSSION

B.A.T, through its Wiggins-Teape (WT) subsidiary, is the world's second largest manufacturer of CCP, a complex coated paper used to make multi-part business forms. WT does not sell CCP in the U.S. Appleton, a division of NCR, is the world leader and the largest U.S. producer of CCP. In 1978, B.A.T acquires Appleton from NCR. Does the B.A.T acquisition of Appleton violate Section 7 of the Clayton Act by reason of the actual potential competition doctrine?

The actual potential doctrine postulates that in oligopolistic markets, Section 7 may be violated when the opportunity for injecting deconcentration or other procompetitive benefits through future de novo or toehold entry is eliminated as a result of a leading firm acquisition by a potential entrant. There is no issue in this case of the perceived potential competition doctrine, the second branch of the potential competition hypothesis. Under the perceived potential theory, present competition in a concentrated market is said to be adversely affected when the discretion-tempering impact of a firm on the fringe and perceived to be a potential independent entrant is eliminated through the acquisition of a [111] leading company in the targeted market. *United States v. Marine Bancorporation,* 418 U.S. 602, 624–25 (1974).[324]

In contrast to the perceived theory, the actual potential doctrine assumes that the acquiring firm exerts no competitive influence on the targeted market prior to the merger, but competition would have been heightened had the acquirer entered by alternate means. Although the Supreme Court has twice reserved ruling directly on the validity of the actual potential theory, *United States v. Marine Bancorporation, Inc.,* 418 U.S. 602, 625, 639 (1974), *United States v. Falstaff Brewing Corp.,* 410 U.S. 526, 537 (1973),[325] the Commission has emphatically endorsed it. The circuit courts, on the other hand, have for the most part not dwelled on the validity of the theory,[326] grappling instead with the adequacy of the record facts required under the various elements of the doctrine as articulated by the Supreme Court and the Commission; that is, the competitiveness of the targeted market, the number of potential entrants, the capacity, interest, and economic [112] incentive for entering de novo or by toehold, and the likelihood that successful alternate entry would have occurred in the reasonably near future with the result that deconcentration or other significant pro-competitive effects would have been achieved. *Ecko Products*, 65 F.T.C. 1163 (1964), *aff'd*, 347 F.2d 745 (7th Cir. 1965); *Budd Co.*, 86 F.T.C. 518, 580 n. 5 (1975); *British Oxygen Co.*, 86 F.T.C. 1241 (1975), *rev'd and remand sub nom. BOC Int'l v. FTC*, 557 F.2d 24 (2d Cir. 1977); *Brunswick Corp.*, 94 F.T.C., 1174 (1979), *modified as to relief*, 96 F.T.C. 151 (1980), *aff'd as modified sub nom. Yamaha Motor Co. v. FTC*, 657 F.2d 971 (8th Cir. 1981), *cert. denied*, 456 U.S. 915 (1982); *Heublein, Inc., et al.*, 96 F.T.C. 385 (1980); *Tenneco, Inc.*, 98 F.T.C. 464 (1981), *rev'd on other grounds*, 689 F.2d 346 (2d Cir. 1982).

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[324] Not only is the perceived potential theory absent from the complaint, but there was no proof offered under *any* theory that U.S. CCP producers identified WT as an imminent entrant.

[325] *But see* dictum in *FTC v. Procter & Gamble Co.,* 386 U.S. 568, 575 (1967) ("If Procter had actually entered, Clorox's dominant position would have been ended and concentration of the industry reduced").

[326] A clear endorsement for the theory, however, appears in *Mercantile Texas Corp v. Board of Governors, etc.* 638 F.2d 1255, 1265 (5th Cir. 1981) ("We believe that the doctrine has logical force and is consonant with the language and policy of the Clayton Act.").

In the absence of a definitive statement to the contrary by the Supreme Court, I am bound by the Commission's clear holding as to the validity of the actual potential doctrine.

As I have indicated in the Findings, CCP production for resale is a tightly blockaded oligopoly which easily qualifies as a market ripe for application of the actual potential doctrine as articulated by the Commission. On the threshold issue of market definition, in its recent synthesis of its views the Commission has emphasized that irrespective of the criteria [113] used (cross-elasticities or "less direct market indicia"),[327] the purpose of market analysis (consistent with the objective of preventing or eliminating structural conditions which are conducive to collusion or tacit interdependent conduct) is to determine "whether related products or services place a significant constraint on the ability of the merging firms to raise prices, limit supply or lower quality."[328] In a word, [114] OTC is not a significant constraint on CCP prices, supply, or quality. The two products are priced differently from one another with CCP enjoying a persistent premium of 15% or more over OTC. The reliable evidence on cross-elasticities shows that small changes in the size of this premium has no impact whatever on the demand for either product. The premium persists because in certain applications CCP is a non-substitutable product while in others there is a marked preference based on convenience and cleanliness. Thus in their everyday business decisions relating to price, increases in productive capacity, or quality, CCP manufacturers look to what other CCP manufactures are likely to do and these decisions are not [115] constrained by OTC considerations. Moreover, there is no supply-side flexibility between the two products since OTC manufacturing facilities cannot be converted to CCP, and CCP facilities cannot be switched profitably to OTC manufacture.

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[327] These "less direct market indicia" include:

> . . . the persistence of sizeable price disparities for equivalent amounts of different products; the presence of sufficiently distinctive characteristics which render a product suitable only for a specialized use; the preference of a number of purchasers who traditionally use only a particular kind of product for a distinct use; or the judgment of purchasers or sellers as to whether products are in fact competitive. In addition, where firms routinely study the business decisions of other firms, including their pricing decisions, such evidence may reflect a single product market.

Statement of Federal Trade Commission Concerning Horizontal Mergers (June 14, 1982), *reprinted in* Trade Reg. Rep. (CCH) No. 546 at 84 (special supplement to 2 Trade Reg. Rep. (CCH) ¶ 4225 (June 16, 1982)).

[328] *Ibid.* The constraints on the ability of the merging firm to raise prices is also the focus of market definition in the Justice Department's Merger Guidelines which provide that "the Department will hypothesize a price increase of five percent and ask how many buyers would be likely to shift to the other products within one year." In evaluating substitutability the Department will consider:

> (1) Evidence of buyer's perceptions that the products are or are not substitutes, particularly if those buyers have shifted purchases between the products in response to changes in relative price or other competitive variables;
>
> (2) Similarities or differences between the products in customary usage, design, physical composition and other technical characteristics;
>
> (3) Similarities or differences in the price movements of the products over a period of years; and
>
> (4) Evidence of sellers' perceptions that the products are or are not substitutes, particularly if business decisions have been based on those perceptions.

U.S. Dept. of Justice, Merger Guidelines, Section IIA (June 14, 1982), *reprinted in* 2 Trade Reg. Rep. (CCH) ¶ 4502 at 6881-8 (Aug. 9, 1982) [hereinafter "Merger Guidelines"].

That the CCP resale market is highly concentrated is not in dispute.[329] Furthermore, respondents have not come close to showing that this market is performing competitively; to the contrary, the reliable evidence points to a concentrated, extremely anti-competitive oligopoly, sorely in need of a successful new entrant.

As for the other elements of the actual competition doctrine, there are the related issues of incentives and [116] disincentives to entry and whether WT enjoyed a unique advantage in overcoming the most significant barrier. The incentives are obvious: in 1978, when presumably a decision would have been made about entering de novo had the Appleton acquisition been denied, the U.S. CCP industry was in the midst of a period of sharp growth and high profits. Both conditions were expected to continue. Respondents, however, claim that the path leading to attractive financial returns in the U.S. market was strewn with problems—patents, technology, paper supply, distribution, personnel, and many others. While there may be some substance to some of the problems, there is nothing in the case law which suggests that alternative entry will be regarded as feasible only if respondent had before it a problem-free path to success. What complaint counsel must prove is that with respect to entry-blocking barriers (not all "problems") WT enjoyed unique advantages which made entry feasible and likely to succeed.

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[329] Concentration in the CCP market, whether Moore's in-house production is included or not, far exceeds the threshold HHI of 1800 which is likely to provoke a Justice Department challenge of a potential competition merger. Merger Guidelines, Section IVA3(a), 2 Trade Reg. Rep. (CCH) ¶ 4504 at 6881–16. Although the internal production of Moore's is presumptively part of the overall market according to the Merger Guidelines, Section IIB3, 2 Trade Reg. Rep. (CCH) ¶ 4502 at 6881–9, in calculating concentration ratios and market shares, the Merger Guidelines would seem to exclude CCP produced in-house by Moore since "the Department will include only those sales likely to be made or capacity likely to be used in the geographic market in response to a small but significant and non-transitory increase in price." Merger Guidelines, Section IID, 2 Trade Reg. Rep. (CCH) ¶ 4502 at 6881–11. There is no evidence that Moore has responded to any price increase by selling in the open market or that it has any intention to engage in such competition in the future so as to "frustrate an effort by the sellers of the relevant product to exercise market power." Merger Guidelines, Section IIB3 note 20, 2 Trade Reg. Rep. (CCH) ¶ 4502 at 6881–9.

From my reading of the record, it is plain that mastery of the difficult capsule coating technology with a cost-efficient manufacturing process represents a significant barrier to entry into the U.S. CCP market.[330] With respect to this barrier, [117] the record shows that in 1978 WT officials had supreme confidence in their ability to make CCP using their own clay-based technology. Moreover, on the basis of almost a 30-year relationship with Appleton, and with a license to manufacture in the U.S. with the NCR technology which Appleton was willing to grant, it is likely that WT could have overcome the differences between clay and resin and produced a high-quality, resin-based CCP for the U.S. market. These advantages alone immediately separate WT from the entire class of potential entrants nominated by respondents who either lack the technological know-how or are legally barred from using the technology in the U.S. and thus cannot be considered as serious potential candidates.[331] However, the non-integrated mode of entry advanced by complaint counsel's expert, Dr. Horowitz, has the effect of not only eliminating any presumption that WT could have matched the efficiencies of Appleton or Mead, but it also raises serious doubts about even attempting entry notwithstanding WT's mastery of the technology. [118]

On the question of the feasibility of alternate entry, after calculating the pluses and minuses (for example, the lure of participation in the world's largest and most profitable CCP market weighed against the problems of switching to a resin-based CF and setting up a distribution system) it is reasonable to infer that because the incentives were so palpable, and the disincentives were not so overwhelmingly discouraging, that WT would have looked at the bottom line—that is, would alternate entry have been profitable? The burden of producing evidence on this issue lies with complaint counsel who must prove that WT's examination of entry alternatives would have revealed that it could have entered the U.S. CCP market through some economically attractive means other than the Appleton acquisition.

In evaluating the evidence on alternate entry, I agree at the outset with complaint counsel that the issue is not resolved by the so-called "Cummings Report" which shows that de novo entry or a toehold acquisition were specifically rejected in 1978 when the attractiveness of the Appleton acquisition was being aggressively advocated by WT corporate planners. The Cummings Report was a brief in favor of the Appleton acquisition. Moreover, it was prepared with knowledge that the issue of alternate forms of entry has antitrust consequences, and it is fairly predictable (as one court has noted) that—[119]

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[330] For recognition of specialized manufacturing and technological experience as an entry barrier *see Kennecott Copper Corp. v. FTC*, 467 F.2d 67 (10th Cir.), *cert. denied* 410 U.S. 930 (1974); *United States v. Black and Decker Mfg. Co.*, 430 F.Supp. 729 (D. Md. 1976).

[331] *See* Merger Guidelines, Section IVA3(c), 2 Trade Reg. Rep. (CCH) ¶ 4504 at 6881–16. ("Other things being equal, the Department is increasingly likely to challenge a merger as the number of other similarly situated firms decreases below three and as the extent of the entry advantage over non-advantaged firms increases.")

> . . . once the legal issues are known to astute corporate counsel, future facts as to corporate intent can be expected to be shaped under careful legal guidance to negate any inference that a corporation intended to enter any particular market which it later enters by merger.[332]

Nor is the entry issue disposed of by testimony of respondents' officials to the effect that under no circumstances would B.A.T have entered the U.S. market except by the Appleton acquisition. It is so patently in respondents' self-interest to present such testimony that "its utility is sharply limited."[333] Besides, the views of company officials about the desirability of leading-firm acquisition and the unattractiveness of de novo entry reflects a management perspective respecting competition which has little relevance to the antitrust issue at hand. Thus to WT, acquisition of Appleton and maintenance of Appleton's 50% or more market share against any erosion was desirable to "ensure stability and real market leadership."[334] In other words, clearly if WT had its way, it would prefer to enter the U.S. CCP market in a mode which does not upset the competitive status quo. The issue here is what [120] would have happened if WT had not had its way because of the antitrust laws of the United States. Or as the district court observed in *Phillips Petroleum:*

> . . . entry by acquisition is almost always more attractive to management than independent entry. An acquisition enables a company to quickly capture the acquired company's share of the market. Risk is minimized. Moreover, the competitive force of the acquired company, which would be present if the acquiring company entered unilaterally, is eliminated. It will thus be in a company's self-interest to present subjective evidence of a lack of any intent to enter the market unilaterally. . . .[335]

By the same token, the alternate entry issue is not resolved by a showing that Appleton and Mead have experienced a level of growth and profits sufficient to attract the interest of WT. It is one thing for a firm to be interested in a market, but until that interest manifests itself in an investment decision, the only proper inference to be drawn is that had the acquisition route been blocked, B.A.T would have made an evaluation of the profitability of another form of entry. Complaint counsel concede this point more or less since they concentrated their efforts during the hearings on constructing and demolishing various economic models—expert estimates of potential profit based upon assessment of risks, costs, and rate of return under various hypothetical conditions—which were created [121] specifically for this litigation in an attempt by the government to prove the feasibility of de novo entry and by respondents to prove the impracticality of this option.

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[332] Brodley, *Oligopoly Power Under the Sherman and Clayton Acts - From Economic Theory to Legal Policy,* 19 Stan. L. Rev. 285, 357-58 (1967), *quoted in United States v. Phillips Petroleum Company,* 367 F.Supp. 1226, 1238 (D.C. Calif. 1973).

[333] *United States v. Falstaff Brewing Corp.,* 410 U.S. 526, 565 (1973) (concurring opinion of Mr. Justice Marshall).

[334] RX 162-1.

[335] 367 F.Supp. at 1238.

The approach taken by complaint counsel is supported by the emphasis which the Commission, the courts, and other authorities have placed on objective facts relating to the feasibility of alternate entry such as the actual experience of other firms,[336] the existence of any special cost advantages or disadvantages to the new entrant,[337] and whether entry is attractive in the sense that expected profits are likely to survive the output expansion represented by the production of the new firm.[338] As it happens, in a seminal article on the subject, a leading antitrust scholar seems to have anticipated the very "modeling" approach taken by complaint counsel by suggesting an inquiry into the prospects for future profit—that is, having experts predict what the range of profit would have been if independent entry has been attempted, and whether [122] the predicted profit level would have induced independent entry.[339]

In short, there is ample precedent in Commission and court cases as well as respected academic support for the proposition that economic models grounded on objective facts alone may serve as a surrogate for the feasibility of alternate entry. Still to be resolved, however, is the question of whether the models constructed by complaint counsel for this case can be used with a reasonable degree of confidence to predict an entry decision. Or to put it somewhat differently, it must be determined whether the record contains a model whose assumptions and factual [123] predicates have withstood the adversarial process to the point that it represents convincing evidence that it was in B.A.T's economic self-interest to attempt a greenfield entry. Since the burden rests with complaint counsel, this means that their entire case depends on the validity of the Horowitz-Painter models.

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[336] *Heublein, Inc.*, 96 F.T.C. 385, 588 (1980).

[337] *Tenneco, Inc. v. FTC*, 689 F.2d 346, 354 (2d Cir. 1982).

[338] 5 P. Areeda and D. Turner, *Antitrust Law*, ¶ 1121c2. at 109 (1980).

[339] Pitofsky, *Joint Ventures Under The Antitrust Laws: Some Reflections on the Significance of Penn-Olin*, 82 Harv. L. Rev. 1007, 1028–29 (1969). However, another highly respected scholar has warned (with remarkable prescience) that the profit modeling approach will open the door to evidentiary conflict and unmanageable complexity in litigation as "competing experts escalate the subtlety of the analysis." Brodley, *Potential Competition Under the Merger Guidelines*, 71 Cal. L. Rev. 376 at 391 (1983). Professor Brodley's own approach to potential competition, which is based upon geographic and product proximity (*Ibid.* and Brodley, *Potential Competition Mergers: A Structural Synthesis*, 87 Yale L.J. 1 (1977)), has been rejected by the Commission with a concurring statement by then Commissioner Pitofsky. Statement of the Federal Trade Commission Regarding Staff Recommendation of Advance Notice of Proposed Rulemaking on Potential-Competition Mergers [1969–1983 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 50,419 at 55,943 (October 7, 1980). Subsequently, the modeling approach may have received some support from *Republic of Tex. Corp. v. Board of Gov. of Fed. Res.*, 649 F.2d 1026, 1047 (5th Cir. 1981) but with the added caveat that the plaintiff must offer "a persuasive rationale" showing that based upon an analysis of comparative profitability the acquiring firm would prefer entry into the targeted market over other investment opportunities.

There are several reasons why the government's models do not inspire confidence. To begin with, the reliability of the models initially rested on Horowitz's supposition that the non-integrated new entrant (WT) would simply trade efficiencies with integrated Appleton with the result that manufacturing costs of one could be borrowed by the other for the purpose of creating a model. One searches the record, however, in vain for solid support for this facile trade-off, and apparently not sure themselves that divestiture can rest on such a slender reed, complaint counsel next attempted to build into their model a non-integration penalty of $85 accompanied by a substantial reduction in "other expenses." For these crucial adjustments, however, there was no testimony at all, complaint counsel relying instead on their adroitness in raising questions about the accuracy of much higher penalties which appear in respondents' pre-litigation business records. But even complaint counsels' consummate skill in cross-examination did not produce evidence which proves that a $85 penalty is clearly right or a $113 penalty (one of several higher penalties which [124] appear in respondents' business records) is clearly wrong. What it did produce is additional doubt about the usefulness of models which are patchwork affairs that pick and choose selectively from another firm's experience when on its face the experience of integrated Appleton may not be germane to the hypothetical non-integrated new entrant.[340] And although it may be possible to make corrective adjustments when the costs of one firm are engrafted onto those of a markedly different firm, the adjustments were not made here with a level of precision that convinces me that the form of U.S. entry posited by Horowitz—a 67,000 ton non-integrated coating operation—would have been profitable enough to attract B.A.T.

It should be understood that I am not holding complaint counsel to an elevated standard of proof which exceeds the "reasonable probability" test for judging the likelihood of independent entry.[341] Certainly, the government is not being [125] asked to create doubt-free economic models which absolutely assure entry. What I am saying is that when a record contains no convincing industry testimony in support of entry in the form of a non-integrated coating operation, or evidence of a past history of successful entry in the mode hypothesized by the government, or contemporaneous internal documents from respondents' own files establishing that a particular investment course was investigated and found to be attractive, and instead complaint counsel stake their claim exclusively on a model constructed for litigation, the bottom-line profitability of [126] that model must be so clearly established and so convincingly defended that it rationally *compels* the conclusion that had the acquisition route been blocked it would have been clearly in the respondents' economic self-interest to invest de novo in a non-integrated 67,000 ton coating operation in the U.S. CCP market. As it happens, putting the models aside, the record evidence indicates that the mode of entry advanced by complaint counsel's expert would have been a departure from what the industry generally regards as the most efficient form of CCP manufacture. As for the reliability of the models, they are simply too speculative and uncertain with respect to the cost of manufacturing to be used to predict a course of business behavior which is not otherwise supported on the record by either contemporaneous documents, or by a track record of success, or by industry opinion as to the likelihood of success. Finally, even if all doubts about the Painter-Horowitz model were resolved in complaint counsel's favor, there is nothing in the record which proves that B.A.T would invest in a U.S. greenfield CCP facility (hardly a risk-free venture) in anticipation of a 10% IRR, the bottom line of complaint counsel's ultimate model.

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[340] Complaint counsel might have attempted to improve on Heitpas' and Elliott's performances (*see* note 225, *supra* and Finding 119), and with the support of an engineering study and expert testimony respecting product mix and costs, perhaps they could have constructed an acceptable model of a non-integrated CCP producer. Instead, they had Horowitz and Painter borrow selectively from integrated Appleton's experience, but they drew the line at using Appleton's pre-litigation assessment of the penalty which arises when base paper is brought in. This crucial void in the record was never adequately filled.

[341] *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158, 175–76 (1964). Complaint counsel devote considerable effort in their briefs to attacking two other articulations of the quantum of proof required in potential cases—Professor Turner's "clear proof" that de novo entry would have been "certain" (Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 Harv. L. Rev. 1313, 1384, 1386 (1965)) and the Fourth Circuit's "unequivocal proof" that an acquiring firm actually would have entered de novo. *FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 294 (4th Cir. 1977). Complaint counsel argue that these standards may have been superceded by later authority (*see, e.g.*, *BOC Int'l Ltd v. FTC*, 557 F.2d 24, 28 (2d Cir. 1977); *Mercantile Texas Corp. v. Board of Governors, etc.*, 638 F.2d 1255, 1268 (5th Cir. 1981)) indicating either a growth in confidence or a decline in apprehension over predicting what businessmen will do in the future if the acquisition is overturned or would have done in the past had the acquisition been blocked. Although I am not as certain as complaint counsel that in this stage of its development

(footnote cont'd)

The complaint should be dismissed for failure of proof. [127]

IV

CONCLUSIONS OF LAW

1. The Federal Trade Commission has jurisdiction over respondents and the subject matter of this complaint.

2. On or about June 30, 1978, respondent B.A.T acquired all of the assets of respondent Appleton from NCR Corporation.

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one can safely discard any potential competition criteria not explicitly repudiated by the Supreme Court, I have proceeded on the premise that the government would have prevailed had it proven that there was available to B.A.T a form of entry which was so demonstrably profitable that it could not rationally be rejected by a firm interested in the targeted market. I believe that this approach is consistent with the formula suggested by Mr. Justice Marshall in his concurring opinion in *Falstaff*, 410 U.S. at 568 (". . . in a case where the objective evidence strongly favors entry *de novo*, a firm which asks us to believe that it does not intend to enter *de novo* by implication asks us to believe that it does not intend to act in its own economic self-interest").

3. At all times relevant to this proceeding, B.A.T and Appleton were engaged in Commerce within the meaning of the Clayton Act.

4. For the purpose of assessing the legality of the acquisition under Section 7 of the Clayton Act, the relevant line of commerce is the manufacture of CCP for resale.

5. The United States is the appropriate geographic market.

6. The U.S. CCP market is highly concentrated, blockaded by a technological entry barrier, dominated by Appleton, and undoubtedly would benefit from the pro-competitive effects of successful new entry.

7. B.A.T (through its WT subsidiary) never sold CCP in the U.S.; however, because of its technological capability and prior [128] relationship with Appleton, it was the most likely potential entrant into the otherwise blockaded U.S. CCP market.

8. Although WT had an interest and an incentive in evaluating the feasibility of U.S. entry, the model of entry advanced by complaint counsel does not constitute reliable, probative, and substantial evidence that it would have been in WT's economic self-interest to enter by means of a non-integrated greenfield coating operation.

9. There was a failure of proof that WT would have entered by toehold acquisition, joint venture, export, or through a licensing arrangement.

Accordingly, the following order should be issued:

ORDER

The complaint is dismissed.

OPINION OF THE COMMISSION

BY DOUGLAS, *Commissioner:*

The 1980 complaint in this matter alleges that B.A.T Industries, Ltd. ("B.A.T")[1] and Appleton Papers, Inc. ("Appleton") violated Section 7 of the Clayton Act, 15 U.S.C. 18, and Section 5 of the Federal

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[1] After the complaint was filed, B.A.T changed its official name to B.A.T Industries PLC. ID at 1 n.1.
The following abbreviations are used in this opinion:

ID – initial decision page number
IDF – initial decision finding number
Tr. – transcript of testimony page number
CX – complaint counsel's exhibit number
CAB – complaint counsel's appeal brief
CRB – complaint counsel's reply brief
CPF – complaint counsel's proposed finding of fact number
CRF – complaint counsel's reply finding of fact number
RX – respondent's exhibit number
RAB – respondent's answering brief
RPF – respondent's proposed finding of fact number
RRF – respondent's reply finding of fact number

Trade Commission Act, 15 U.S.C. 45, when B.A.T acquired the assets of the Appleton Papers Division of NCR Corporation ("NCR") in 1978. More precisely, the complaint alleges that the acquisition might substantially lessen competition or tend to create a monopoly, and unreasonably restrain trade and hinder competition, in the manufacture and sale of chemical carbonless paper ("CCP") in the United States.[2] At the time of the acquisition, B.A.T's Wiggins Teape [2] Group, Ltd. subsidiary ("Wiggins") was the largest CCP producer outside the United States, and Appleton was the largest CCP producer within the United States. ID at 2. The complaint does not allege either that Wiggins competed with Appleton in the United States market or that Wiggins was perceived to be a potential entrant into that market at the time of the acquisition. Instead, it alleges that Wiggins was a significant "actual potential entrant" into the United States market, because (1) the market was highly concentrated and protected by extremely high entry barriers; (2) Wiggins was one of only a few firms that possessed the capability and incentive to enter the market, and would probably have entered the market by other means if it had not acquired Appleton; (3) feasible alternative forms of entry existed, including establishing manufacturing facilities in the United States, establishing joint ventures or licensing relationships with firms not already in the CCP market, acquiring a toehold firm, or exporting CCP into the United States; and (4) the Appleton acquisition eliminated the prospective deconcentration of the United States market from an alternative form of entry, heightened Appleton's dominance of and entry barriers into that market, and may have eliminated the competitive benefits of internal expansion and innovation by B.A.T. [3]

The Administrative Law Judge in this matter dismissed the complaint. In their appeal from that decision, complaint counsel argue that the initial decision should be reversed, and that B.A.T should be ordered (1) to divest Appleton completely,[3] or (2) to divide Appleton into two freestanding CCP operations, either by retaining one plant and selling the other or by selling both plants to different purchasers acceptable to the Commission. CAB at 5, 52–53. B.A.T and Appleton argue in response that the complaint should be dismissed.

This case raises important questions relating to the contours of the actual potential competition doctrine. For the reasons detailed below, including in particular the absence of clear proof that B.A.T would have entered the United States CCP market independently had it not been able to acquire Appleton, the Commission has determined that the allegations of a violation of the actual potential competition doctrine have not been sustained, and that the complaint must therefore be dismissed. [5]

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[2] CCP is a coated paper used to make multipart business forms. A typical CCP form consists of three sheets: a top sheet with a chemically coated back ("CB"); a middle sheet chemically coated on both front and back ("CFB"); and a bottom sheet with a chemically coated front ("CF"). Mechanical or manual pressure applied to the top sheet begins a chemical reaction that transfers images from the top sheet to lower sheets. IDF 16–18.

[3] Pursuant to the proposed divestiture, B.A.T would be permitted to reserve the right to manufacture and sell CCP in the United States, using the Appleton patents and knowhow (as improved since the acquisition).

I. INTRODUCTION

B.A.T, the twenty-eighth largest industrial firm outside of the United States, is chartered in the United Kingdom and has its headquarters in London, England. IDF 1. In fiscal 1977, B.A.T controlled assets valued at $6 billion, and earned $827 million in operating profits on sales valued at $11 billion. IDF 2. Its United States holdings, administered through Batus, Inc., a Delaware corporation, include Appleton (paper), Brown and Williamson (tobacco), Gimbels, Marshal Field, and Saks Fifth Avenue (retailing), and Germaine Monteil and Yardley (cosmetics). In fiscal 1977, B.A.T's sales in the United States and Canada totalled $3 billion. IDF 4. B.A.T has owned Wiggins, a United Kingdom paper manufacturing and merchandising firm, since 1970; Wiggins' sales approximated $920 million in 1978. IDF 5. In 1977, Wiggins sold 85,000 metric tons of "Idem," its brand of CCP, representing 45 percent of total CCP sales in the United Kingdom and Europe and making Wiggins the second largest CCP producer in the world. IDF 6. From 1956 through 1978, Wiggins produced CCP under a series of licenses from NCR Corporation that gave it access to NCR's patents, technology, and knowhow but limited its CCP sales to Europe and other designated areas outside the United States. IDF 7.

NCR Corporation, headquartered in Dayton, Ohio, is primarily engaged in the manufacture of computers, office machines and related products, and business forms. Its sales amounted to approximately $2.3 billion in 1977. IDF 9. In 1954, NCR developed a commercially marketable CCP; it contracted out the [6] manufacture of the product for over a decade to the Appleton Coated Paper Company and other firms. In 1971, after acquiring Appleton, NCR combined Appleton with another CCP producer to form Appleton Papers, Inc. as its CCP manufacturing and selling arm. In 1973, Appleton became the Appleton Papers Division of NCR. IDF 10. In 1978, Appleton produced 213,000 tons of CCP, valued at more than $236 million, making it the largest CCP producer in the world, accounting for approximately 60 percent of CCP sales in the United States alone. IDF 12.

On June 30, 1978, B.A.T acquired Appleton from NCR for $299 million. With that acquisition, B.A.T became the world's largest CCP producer, accounting for over 40 percent of world-wide production. IDF 13–14.

II. THE ACTUAL POTENTIAL COMPETITION DOCTRINE

A. *Economic Principles*

The *actual* potential competition doctrine represents a rather peculiar theory of competitive injury that can best be explained by first comparing and contrasting it with the *perceived* potential competition doctrine, and then developing relevant economic principles to govern its application. The perceived potential competition doctrine postulates that the prospect of entry may pressure firms in oligopolistic markets to behave more competitively than they might otherwise.[4] The perception that entry will occur if prices are raised to supracompetitive levels may in fact produce a competitive [7] equilibrium, regardless of other structural or behavioral characteristics. In this situation, the removal of a perceived prospective entrant through merger or acquisition may weaken the restraint on raising prices and therefore substantially lessen *current* competition or tend to create a monopoly within the meaning of Section 7 of the Clayton Act.[5]

By contrast, the *actual* potential competition doctrine postulates that a merger or acquisition may prevent the relevant market from *becoming* as competitive as it might otherwise become.[6] The theory postulates a market of oligopolistic firms that currently does *not* perform competitively, at least in part because the market incumbents do not perceive any particular firm to be a prospective entrant that constrains their pricing discretion. The theory nevertheless postulates that at least one firm outside the market actually does possess the financial and productive capability, interest and incentive to enter successfully. If that firm then acquires or merges with an incumbent firm, instead of entering the market itself, the market will theoretically not *become* as competitive as it would have become had the outside firm simply entered independently, by [8] means of *de novo* entry, a toehold acquisition, or in some other alternative fashion.[7] In short, the actual potential competition doctrine focuses upon the prospect of *future* injury because a currently noncompetitive industry will not become as competitive as it might have as a consequence of the merger or acquisition at issue. This characteristic limits the doctrine's applicability considerably. As the Second Circuit has indicated, the doctrine

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[4] *E.g.*, P. Areeda and D. Turner, V *Antitrust Law: An Analysis Of Antitrust Principles And Their Application* 69 (1980).

[5] *E.g.*, *United States v. Marine Bancorporation*, 418 U.S. 602, 639–40 (1974); *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 535 n. 13 (1973); *id.* at 559–60 (Marshall, J., concurring); *Mercantile Texas Corp. v. Board of Governors of the Federal Reserve System*, 638 F.2d 1255, 1264 (5th Cir. 1981); *BOC International Ltd v. FTC*, 557 F.2d 24, 26 (2d Cir. 1977).

[6] Areeda and Turner, *supra* note 4, at 69.

[7] *Mercantile Texas Corp. v. Board of Governors of the Federal Reserve System*, 638 F.2d 1255, 1264 (5th Cir. 1981); *see BOC International Ltd. v. FTC*, 557 F.2d at 26.

Precisely defining a "toehold" acquisition is of course difficult. *See, e.g., BOC International, Ltd. v. FTC* 557 F.2d at 26 n. 3 and cases and commentary cited therein. The Commission has previously taken the position that the acquisition of a firm accounting for ten percent or less of sales in a given market should be presumed to be a procompetitive toehold acquisition. *E.g., Beatrice Foods Co.*, 86 F.T.C. 1, 66 n. 8 (1975); *The Budd Co.*, 86 F.T.C. 518, 582–83 (1975). The Department of Justice has determined that it will not challenge acquisitions under the actual or perceived potential competition doctrines if the acquired firm controls five percent or less of production or sales in the target market. *Justice Department Merger Guidelines* (June 14, 1984), *reprinted in* 46 Antitrust & Trade Reg. Rep. Special Supplement (June 14, 1984) *("DOJ Guidelines")*, at S–9.

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> rests on speculation about the future conduct and competitive impact of a firm currently outside the market and perhaps intending to remain so. Even if the likelihood of a firm's entry is a probability, as distinguished from an "ephemeral possibility," . . . its potential entry does not promote existing competition, since at most it may become a competitor *in futuro*.[8] [9]

By contrast, the perceived potential competition doctrine focuses upon the prospect of *current* injury to a state of competition that already exists.

The actual potential competition doctrine rests upon firmest ground when it is virtually certain that, but for the merger or acquisition, the prospective entrant would have entered the market involved on an independent basis in the near future. As the Second Circuit has indicated:

> If there is no showing that the acquiring firm would have entered the market but for the acquisition—and if the acquiring firm is exerting no present influence on the market as a perceived potential entrant, as is concededly the case here—then it cannot be said that the effect of the acquisition "may be substantially to lessen competition," Clayton Act Section 7, 15 U.S.C. Section 18. In such situations, to the contrary, "there may even be a competitive gain to the extent that [the acquiring firm] strengthens the market position of the acquired firm."[9]

If independent entry into the relevant market is unlikely to occur, then the acquisition or merger that actually occurs will almost certainly have no effect on future competitive conditions. Therefore, the likelihood of injury to future competition from the merger or acquisition falls as the likelihood that the outside firm would have actually entered independently falls.

The economically sensible application of the actual potential competition doctrine requires the existence of a number of other necessary conditions as well. First, the relevant [10] product and geographic markets must be both concentrated and performing poorly; that is, they must be oligopolistic and characterized by prices

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Hereinafter, *de novo* entry, entry by means of a toe-hold acquisition, and other forms of entry that are alternatives to entry through merger with or the acquisition of a substantial incumbent firm, will be referred to collectively as "independent entry."

[8] *United States v. Siemens Corp.*, 621 F.2d 499, 504 (2d Cir. 1980) (citation omitted).

[9] *BOC International Ltd. v. FTC*, 557 F.2d at 27–28, *quoting United States v. Falstaff Brewing Corp.*, 410 U.S. at 561 (Marshall, J., concurring).

substantially in excess of marginal cost.[10] Second, barriers to entry must be substantial; however, entry cannot be completely blockaded or the loss of a potential entrant through an acquisition will be of no consequence.[11] Third, only a few firms must be capable of entry, so that the loss of a single firm as a prospective entrant may in fact injure prospective competition.[12]

When all the necessary conditions listed above exist, independent entry may yield more competitive benefits than the acquisition of a leading firm in the target market by an actual potential competitor. However, applying the actual potential competition doctrine too vigorously may insulate inefficient leading firms in noncompetitive markets with substantial barriers to entry from the threat of potential takeovers, without inducing the desired alternative outcome of independent entry. For example, consider an oligopolistic market where entry is very difficult, perhaps due to problems associated with mastering a complex technology, and only a few outside firms (using the same or a similar technology) are capable of recognizing competitive sloth or technical inefficiency in incumbents. In these circumstances, ousting current management through an acquisition [11] might very well improve competitive conditions, but might nevertheless be deterred by overly zealous application of the actual potential competition doctrine. In short, while the doctrine is theoretically sensible, it must be applied with considerable care, lest it create more competitive problems than it solves.

The evidentiary problems associated with the actual potential competition doctrine present almost as many difficulties as its theoretical foundation. The theory presumes that incumbent firms in the target market do not consider the acquiring firm to be a likely potential independent entrant. Because incumbent firms presumably understand industry conditions quite well, however, that creates a strong presumption that the acquiring firm is in fact *not* a potential independent entrant.[13] Incumbent firm perceptions presumably incorporate all publicly available information. Therefore, the best information for establishing that the acquiring firm is in fact a likely actual potential entrant ordinarily will *not* be available to incumbent firms. If publicly available information gives incumbent firms the impression that the acquiring firm is unlikely to enter independently, then it seems likely that the acquiring firm will reach a similar conclusion and not attempt to enter independently. [12]

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[10] *See* Areeda and Turner, *supra* note 4, at 76–80, 88.

[11] *Id.* at 85–88.

[12] *Id.* at 70–71; Brodley, *Potential Competition Under the Merger Guidelines*, 71 Cal. L.J. 377, 378 (1983).

[13] In *perceived* potential competition cases, courts have analogously relied upon the perceptions of incumbent firms to determine whether or not a potential entrant constrains incumbent behavior. *See Tenneco, Inc. v. FTC*, 689 F.2d 346, 358 (2d Cir. 1982); *United States v. Siemens Corp.*, 621 F.2d at 508; *United States v. Black & Decker Mfg. Co.*, 430 F.Supp. 729, 769–73 (D. Md. 1976).

The best evidence that a firm is an actual potential entrant therefore will ordinarily consist of internal, non-public information, such as capital budgets or expansion plans, that makes it clear that the firm would have entered the target market independently had it not been for the merger or acquisition. The credibility of this sort of "subjective" evidence should be heightened by the fact that its existence conflicts with the litigation interests of the acquiring firm.[14] As Areeda and Turner point out:

> The only clearly credible [subjective] evidence [relating to pre-merger entry intentions] is that which is contrary to a firm's litigation interests. The clearest example would be subjective evidence by a firm defending a merger of its affirmative intention to enter independently a market actually entered by merger.[15] [13]

It will often be difficult to secure such evidence. Nevertheless, if the firm's intention to enter independently has become sufficiently concrete to warrant the preparation of capital budgets and other actual steps toward entry, that intention will ordinarily be memorialized in one documentary form or another. The credibility of subjective evidence that the firm would have entered independently but for the acquisition must of course outweigh the credibility of conflicting publicly available information.

B. *Legal Principles*

The Supreme Court has twice reserved judgment on whether an actual potential competition merger may violate Section 7 of the Clayton Act.[16] However, two lower courts have concluded that such a merger or acquisition may violate Section 7 in some circumstances.[17] The Federal Trade Commission has reached the same conclusion, stating that

> a potential entrant's acquisition of a leading firm in a concentrated target market may

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[14] Subjective evidence purportedly establishing the opposite conclusion must be evaluated carefully. An outside firm defending a merger or acquisition has a strong incentive to deny that it would have entered independently if the merger or acquisition had been prevented. As Areeda and Turner point out, testimony "in the course of litigation is the least reliable," but firms that anticipate the possibility of merger or acquisition are also likely to keep internal documents discussing independent entry as negative as possible "until the moment of actual positive steps toward entry." Areeda and Turner, *supra* note 4, at 103–04, *citing United States v. Falstaff Brewing Corp.*, 410 U.S. at 568–69 (Marshall, J., *concurring*). Some courts have nevertheless considered this sort of evidence, at least when objective evidence also makes it doubtful that independent entry would have occurred. *Id.* at 104, *citing United Statees v. Penn-Olin Chemical Co.*, 246 F.Supp. 917, 931–34 (D. Del. 1965), *aff'd by an equally divided Court*, 389 U.S. 308 (1967) and *United States v. Wachovia Corp.*, 313 F.Supp. 632, 636 (W.D.N.C. 1970).

[15] Areeda and Turner, *supra* note 4, at 104.

[16] *United States v. Marine Bancorporation*, 418 U.S. 602, 625, 639 (1974); *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 537 (1973).

[17] *Yamana Motor Co., Ltd. v. FTC*, 657 F.2d 971, 977–79 (8th Cir. 1981), *cert. denied*, 456 U.S. 915 (1982); *United States v. Phillips Petroleum Co.*, 367 F.Supp. 1226, 1232–34 (C.D. Cal. 1973), *aff'd mem.* 418 U.S. 906 (1974). The Second Circuit has on three occasions declined to conclude that an actual potential competition merger may violate Section 7 of the Clayton Act. *Tenneco, Inc. v. FTC*, 689 F.2d 346, 352, 355 (2d Cir. 1982); *United States v. Siemens Corp.*, 621 F.2d 499, 504, 506 (2d Cir. 1980); *BOC International Ltd. v. FTC*, 557 F.2d 24, 28 (2d Cir. 1977).

> violate Section 7 of the Clayton Act if it is likely that, but for the acquisition, the acquiring firm would [14] have entered the target market independently, or through a "toehold" acquisition of a firm lacking a significant share of that market.[18]

Establishing liability through the actual potential competition doctrine requires establishing four separate facts. First, the Commission must establish that the relevant product and geographic markets are concentrated.[19] The precise degree of concentration required has not been conclusively established. However, the Supreme Court has indicated that a high degree of concentration establishes "a *prima facie* case that the . . . market [is] a candidate for the potential competition [15] doctrine."[20] For example, in *Marine Bancorporation*, the Court indicated that the fact that three firms controlled 92 percent of the relevant market made such a *prima facie* showing.[21] The Court has also indicated that the *prima facie* case can be overcome by evidence that the concentration data, "which can be unreliable indicators of actual market behavior," do not "accurately depict the economic characteristics of the [relevant] market."[22]

The Commission has concluded that considerably lower degrees of concentration can satisfy the concentration requirement of the doctrine: [16]

> Four-firm market shares in the range of 50 percent are sufficient to raise concern over the loss of potential competition.[23]

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[18] *Grand Union Co.*, 3 Trade Reg. Rep. (CCH) ¶22,050 (July 18, 1983), at 22,708 (citations omitted); *accord, Tenneco Inc.*, 98 F.T.C. 464, 577 n.3 (1981), *rev'd on other grounds*, 689 F.2d 346 (2d Cir. 1982); *Heublein, Inc.*, 96 F.T.C. 385, 583 n.22 (1980); *Brunswick Corp.*, 94 F.T.C. 1174, 1267 n.25 (1979), *modified as to relief*, 96 F.T.C. 151 (1980), *aff'd as modified sub nom. Yamaha Motor Co. v. FTC*, 657 F.2d 971 (8th Cir. 1981), *cert. denied*, 456 U.S. 915 (1982).

[19] *United States v. Marine Bancorporation*, 418 U.S. at 630–31; *Tenneco, Inc. v. FTC*, 689 F.2d 346, 352–53 (2d Cir. 1982); *Mercantile Texas Corp. v. Board of Governors Of The Federal Reserve System*, 638 F.2d at 1266–67; *United States v. Siemens Corp.*, 621 F.2d at 505; *Grand Union Co.*, ¶22,050 at 22,709; *Heublein, Inc.*, 96 F.T.C. at 584; *Brunswick Corp.*, 94 F.T.C. at 1269. This requirement applies to both actual and perceived potential competition cases. *United States v. Marine Bancorporation*, 418 U.S. at 630–31. Areeda and Turner argue that a market "may be presumed to be non-competitive" when the same four firms have accounted for seventy-five percent of the target market (or sixty-five percent, when the eight-firm concentration ratio is ninety percent) for five years prior to the merger, unless "concentration has been declining and will probably decline below the specified ratios." Areeda and Turner, *supra* note 4, at 70.

[20] *United States v. Marine Bancorporation, Inc.*, 418 U.S. at 631; *accord, Republic of Texas Corp. v. Board of Governors of Federal Reserve System*, 649 F.2d 1026, 1045–46 (5th Cir. 1981) (four-firm ratio of 72.4 percent sufficient to establish *prima facie* case); *Mercantile Texas Corp. v. Board of Governors Of The Federal Reserve System*, 638 F.2d at 1267 (four-firm ratios of 86.1 percent and 73.8 percent in two relevant markets sufficient); *United States v. Black & Decker Mfg. Co.*, 430 F.Supp. 729, 748–49, 755 (D. Md. 1976) (four-firm ratio of more than 75 percent sufficient); *Grand Union Co.*, ¶22,050 at 22,711; *Tenneco, Inc.*, 98 F.T.C. 464, 577, 583–84 (1981), *rev'd on other grounds*, 689 F.2d 346, 352 (2d Cir. 1982) (court of appeals concluded that four-firm ratio in excess of 90 percent, and two-firm ration in excess of 77 percent, sufficient).

[21] *United States v. Marine Bancorporation*, 418 U.S. at 630–31.

[22] *Id.* at 631; *accord, Tenneco, Inc. v. FTC*, 689 F.2d at 353; *United States v. Siemens Corp.*, 621 F.2d at 506; *United States v. Hughes Tool Co.*, 415 F.Supp. 637, 643, 645 (C.D. Cal. 1976); *United States v. Falstaff Brewing Corp.*, 383 F.Supp. 1020, 1022–23 (D.R.I. 1974), *on remand from* 410 U.S. 526 (1973).

[23] *Tenneco, Inc.*, 98 F.T.C. at 584; *accord, Heublein, Inc.*, 96 F.T.C. at 584–85 (four-firm concentration of 47.9 percent, two-firm concentration ratio of 41.9 percent sufficient); *Budd Co.*, 86 F.T.C. 518, 574–77 (1975) (four-firm ratio of 56 percent–61 percent prior to the merger sufficient); *The Bendix Corp.*, 77 F.T.C. 731, 826 (1970) (four-firm concentration ratio of 80.8 percent sufficient), *rev'd and remanded on other grounds*, 450 F.2d 534 (6th Cir. 1971).

However, the Commission has indicated more recently that the strength of the presumption, and the strength of the evidence needed to overcome it, vary directly with the degree of market concentration. In *Grand Union,* the Commission concluded that four-firm concentration ratios ranging from 49 percent to 72 percent in the thirteen markets under consideration were sufficient to trigger additional analysis, but that the respondents succeeded in rebutting the presumption in most of those markets.[24] The Justice Department has indicated that it is ordinarily unlikely to challenge potential competition mergers, whether actual or perceived, unless the Herfindahl-Hirschman Index in the acquired firm's market exceeds 1800.[25] As a necessary corollary, the market must be characterized by significant barriers to entry. The Justice Department has concluded that barriers should be as high as in horizontal merger [17] cases, in which the relevant question is whether a "small but significant and nontransitory" price increase would attract new entry.[26]

In addition to establishing that the target market is concentrated, the Commission must second establish that independent entry would result in

> a substantial likelihood of ultimately producing deconcentration of [the target] market or other significant procompetitive effects.[27] [18]

Third, the acquiring firm must be one of only a few equally likely actual potential entrants, since eliminating one of many potential entrants could not be expected to eliminate substantial future competition.[28]

Fourth and finally, the Commission must establish that the acquiring firm would have entered the market independently, either *de novo* or by making a toehold acquisition, if it had not acquired the target

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[24] *Grand Union Co.,* ¶22,050 at 22,712, 22,714. The Commission also noted the greater reliability of Herfindahl-Hirschman Indexes, relative to concentration ratios, as a basis for assessing concentration levels. *Id.* at 22,711. The parties have provided both concentration measures in this case.

[25] *DOJ Guidelines, supra* note 7, at S–9.

[26] *Id.* at S–6, S–9.

[27] *United States v. Marine Bancorporation,* 418 U.S. at 633; *accord, Tenneco, Inc. v. FTC,* 689 F.2d at 352; *Brunswick Corp.,* 94 F.T.C. 1174, 1269 (1979), *aff'd as modified sub nom. Yamaha Motor Co., Ltd. v. FTC,* 657 F.2d 971, 977–78 (8th Cir. 1981), *cert. denied,* 456 U.S. 915 (1982); *Republic of Texas Corp. v. Board of Governors of Federal Reserve System,* 649 F.2d at 1047; *Mercantile Texas Corp. v. Board of Governors of Federal Reserve System,* 638 F.2d at 1270 (not enough to show that entry will "shake things up"; must show "lasting impact"); *BOC International Ltd. v. FTC,* 557 F.2d at 27–28; *Grand Union Co.,* ¶22,050 at 22,709; *Heublein, Inc.,* 96 F.T.C. at 584. Areeda and Turner would, absent "clear evidence to the contrary," presume "a significant procompetitive effect from alternative methods of entry" if the acquired firm "is a significant competitive factor in the market—with 10 percent or more of sales or a substantial and steadily expanding share." Areeda and Turner, *supra* note 4, at 71.

[28] *E.g., Republic of Texas Corp. v. Board of Governors of Federal Reserve System,* 649 F.2d at 1047; *Mercantile Tex. Corp. v. Board of Governors of Federal Reserve System,* 638 F.2d at 1267; *FTC v. Atlantic Richfield Co.,* 549 F.2d 289, 300 (4th Cir. 1977); *United States v. First National State Bancorporation,* 499 F.Supp. 793, 814 (D.N.J. 1980); *United States v. Black & Decker Mfg. Co.,* 430 F.Supp. 729, 771–72 (D. Md. 1976); *United States v. Hughes Tool Co.,* 415 F.Supp. 637, 646 (C.D. Cal. 1976); *Grand Union Co.,* ¶22,050 at 22,709; *Heublein, Inc.,* 96 F.T.C. 385, 588–89 (1980); Areeda and Turner, *supra* note 4, at 70–71.

The Justice Department would be unlikely to challenge a potential competition merger or acquisition—either

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firm.[29] Establishing this factor requires showing that the acquiring firm possessed the "capabilities, economic incentives, and interest to enter the target market," and that entry by a means other than the acquisition would have [19] been feasible.[30] It also requires establishing that independent entry would have occurred within the near future.[31] Not surprisingly, this fourth issue has proven to be the most difficult to resolve in actual potential competition cases.

In his article on conglomerate mergers, Donald F. Turner argued that clear proof that entry would have occurred should be required:

> [W]hen the *only* alleged anticompetitive consequence of a merger is the elimination of what would have been a new entrant in a tight oligopoly, there must, in order to support prohibition, be clear proof that the firm would in fact have entered—an admittedly rare case, and one bound to become even less frequent if this rule were adopted.[32]

The Fourth Circuit has adopted this position, concluding that the Commission must present "clear proof" that the firm would have entered the market but for the acquisition, and that "little [20] evidence is required to prove that there would not be *de novo* entry."[33] The Second Circuit has similarly concluded that *if* the actual potential competition doctrine is a viable doctrine, then the Commission must adduce clear proof that entry would occur.[34] The Fifth Circuit, although holding that independent entry must be at least "reasonably probable," has required proof of a "persuasive rationale" that the acquiring firm would prefer independent entry "over other opportunities for expansion or investment."[35] Among the Circuit Courts of

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actual or perceived—if the "entry advantages" of the outside firm (or comparable advantages) are possessed by three or more other firms. *DOJ Guidelines*, *supra* note 7, at S-9; *accord*, Areeda and Turner, *supra* note 4, at 70.

[29] *United States v. Marine Bancorporation*, 418 U.S. at 633; *Heublein, Inc.*, 96 F.T.C. at 584. In *perceived* potential competition cases, by contrast, it may not be necessary to establish that the acquiring firm would have entered independently; the key question is whether incumbent firms *believe* that the acquiring firm may enter. *United States v. Falstaff Brewing Corp.*, 410 U.S. at 533–34.

[30] *Grand Union Co.*, ¶22,050 at 22,709; *accord*, *Brunswick Corp.*, 94 F.T.C. at 1269.

[31] *BOC International Ltd v. FTC*, 557 F.2d at 28–30 ("the near future"); *Mercantile Texas Corp. v. Board of Governors*, 638 F.2d at 1271–72 (independent entry should be expected within two or three years); *Republic of Texas Corp. v. Board of Governors of the Federal Reserve System*, 649 F.2d 1026, 1047 (5th Cir. 1981) (within a specified "range of months or years").

[32] Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 Harv. L. Rev. 1313, 1384 (1965). Turner notes that the case against the merger would be strengthened if the acquiring firm were a *recognized* potential entrant, so that it *currently* influences the behavior of incumbent firms; that is, that it is a *perceived* potential entrant rather than simply an *actual* potential entrant. More recently, Areeda and Turner have taken the position that one should require a showing that the acquiring firm "would probably have entered the market within a reasonable period of time"; to establish that they would require "proof that (1) the firm has the requisite economic capabilities for substantial de novo entry and (2) such entry is economically attractive to it." Areeda and Turner, *supra* note 4, at 70.

[33] *FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 294–95 (4th Cir. 1977).

[34] After initially adopting the "reasonable probability" standard, the Second Circuit has now recognized its problems and endorsed the "clear proof" standard instead. *Tenneco, Inc. v. FTC*, 689 F.2d 346, 352 (2d Cir. 1982) ("would likely have entered the market in the near future either *de novo* or through toehold acquisition"); *United States v. Siemens Corp.*, 621 F.2d 499, 506–07 (2d Cir. 1980) ("at least a 'reasonable probability' that the acquiring firm would enter the market . . . and preferably clear proof that entry would occur . . ."); *BOC International Ltd. v. FTC*, 557 F.2d 24, 28–29 (2d Cir. 1977) ("reasonable probability").

[35] *Republic of Texas Corp. v. Board of Governors of Federal Reserve System*, 649 F.2d 1026, 1047 (5th Cir. 1981); *Mercantile Texas Corp. v. Board of Governors of Federal Reserve System*, 638 F.2d 1255, 1265, 1268–69 (5th Cir. 1981).

Appeal, only the Eighth Circuit has actually sustained liability under Section 7 under the theory that the respondent was an actual potential entrant into the relevant market. It determined that the respondent "probably" would have entered the relevant market independently were it not for the formation of the joint venture at issue.[36] In short, the Second and Fourth Circuits have [21] adopted the "clear proof" standard, the Fifth Circuit has adopted a variant of the "reasonable probability" standard (*i.e.*, "persuasive rationale") which, in practice, is very close to the "clear proof" standard, and the Eighth Circuit has adopted the "reasonable probability" standard.

Our review of the legal and economic bases for the actual potential competition doctrine has persuaded us that clear proof that independent entry would have occurred but for the merger or acquisition should be required to establish that a firm is an actual potential competitor. The actual potential competition doctrine focuses upon future rather than current competitive conditions. Therefore, even if all the conditions of the doctrine are currently satisfied, there is no guarantee that these conditions will persist until the future time at which independent entry might occur. The likelihood of injury to future competition may therefore not be particularly great even if independent entry but for the merger or acquisition is a virtual certainty. The likelihood of injury will fall substantially if independent entry is only reasonably probable. Moreover, as the Second, Fourth and Fifth Circuits have all recognized, the "reasonable probability" standard is quite ambiguous. The difficulties that the courts have had in identifying the evidence that will show that independent entry is reasonably probable confirm the correctness of that view. For these reasons, we therefore adopt the "clear proof" standard.

Determining whether the acquiring firm is an actual potential entrant requires a detailed examination of its financial and managerial capabilities and interests, and its **[22]** incentive to enter the target market in some fashion other than by acquiring a substantial incumbent firm in that market.[37] Much of the evidence relating to capabilities, interests, and incentives can be objective.[38] For example, evidence as to the financial resources of the acquiring firm is relevant to determining its *capacity* to enter independently. Similarly, evidence that the firm has acquired firms in related product or geographic markets may help to establish its *interest* in entering the market in question.

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[36] *Yamaha Motor Co., Ltd. v. FTC*, 657 F.2d 971, 977–79 (8th Cir. 1981), *cert. denied*, 456 U.S. 915 (1982).

[37] *See, e.g., United States v. Marine Bancorporation*, 418 U.S. 602, 624–25 (1974); *Tenneco, Inc v FTC*, 689 F.2d at 353–55; *Yamaha Motor Co. v. FTC*, 657 F.2d 971, 978–79 (8th Cir. 1981), *cert. denied*, 456 U.S. 915 (1982); *Mercantile Tex. Corp. v. Board of Governors of Fed. Reserve Sys.*, 638 F.2d 1255, 1268–70 (5th Cir. 1981); *United States v. Siemens Corp.*, 621 F.2d 499, 506–08 (2d Cir. 1980); *United States v. Black & Decker Mfg. Co.*, 430 F.Supp. 729, 756–60 (D. Md. 1976); *United States v. Phillips Petroleum Co.*, 367 F.Supp. 1226, 1239–51 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906; *Grand Union Co.*, ¶22,050 at 22,714; *Tenneco, Inc.*, 98 F.T.C. 464, 586–603 (1981); *rev'd on other grounds*, 689 F.2d 346 (2d Cir. 1982); *Heublein, Inc.*, 96 F.T.C. 385, 584–88 (1980). *But see Sun Newspapers, Inc. v. Omaha World-Herald Co.*, 1983–2 Trade Cas. (CCH) ¶65,522 (D. Neb.), *modified on other grounds and aff'd per curiam*, 713 F.2d 428 (8th Cir. 1983) (court entered preliminary injunction prohibiting proposed acquisition by one firm of a potential competitor without detailed examination).

[38] Areeda and Turner define "objective" evidence in antitrust cases to be circumstantial evidence, consisting largely of observable economic data such as a market's profitability or the previous behavior of a firm. By contrast, they define "subjective" evidence to include, for example, statements by officers of a firm relevant to the likelihood

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Finally, evidence that independent entry likely would be substantially more profitable than alternative entry modes may help to establish the acquiring firm's *incentive* to enter [23] independently.[39] The Fifth Circuit Court of Appeals has concluded that a firm should be considered to possess such an incentive

> [i]f the expected profits from independently entering [the relevant market] are markedly higher than those expected from other opportunities . . .[40]

The best evidence concerning the incentives of the acquiring firm to enter independently, however, is likely to be subjective; that is, how did the firm evaluate its independent entry prospects? Did it find them to be sufficiently attractive to warrant preparing concrete capital investment plans? Did its corporate management approve those plans? As we noted above, the most probative evidence to reach this finding ordinarily would be evidence that is *not* available to incumbent firms. Moreover, simply establishing an incentive to enter by acquiring a large incumbent firm is not sufficient. The Commission must establish that the respondent intended to enter *independently* [24] because entry in that fashion rather than through a more substantial merger or acquisition ordinarily entails greater risks and higher costs.[41]

The quality of subjective evidence on this issue is crucially important. Internal management studies prepared contemporaneously with or prior to the acquisition represent the best evidence, because they provide the best guide to discerning whether or not the corporation involved actually contemplated some form of independent entry during the relevant time period. For example, a directive from corporate management to prepare a capital acquisition plan, and to begin making the capital expenditures needed for independent entry, would

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that it would enter independently. *See* Areeda and Turner, *supra* note 4, at 103–114; *accord, e.g., Mercantile Texas Corp. v. Board of Governors of Federal Reserve System*, 638 F.2d at 1269.

[39] *See, e.g., United States v. Marine Bancorporation*, 418 U.S. at 640, 642; *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158, 175 (1964).

[40] *Mercantile Texas Corp. v. Board of Governors of Federal Reserve System*, 638 F.2d 1255, 1269 (5th Cir. 1981); *accord, Republic of Texas Corp. v. Board of Governors of Federal Reserve System*, 649 F.2d at 1047. The Fifth Circuit has indicated that such a profitability study should consider the profit levels enjoyed by incumbent firms, any competitive advantages or disadvantages that the acquiring firm as an independent entrant would confront (such as the costs of entry), and the profitability of alternative investment opportunities. *Mercantile Texas Corp. v. Board of Governors of Federal Reserve System*, 638 F.2d at 1269.

[41] *Tenneco, Inc v. FTC*, 689 F.2d at 353–55; *Grand Union Co.*, ¶22,050 at 22,715–16; Douglas, *Risk In The Equity Markets: An Empirical Appraisal Of Market Efficiency*, 9 Yale Economic Essays (Spring, 1969); Areeda and Turner, *supra* note 4, at 108.

be strongly probative.[42] This type of study may often be difficult to secure. However, the consequences of that problem are substantially outweighed by the danger of relying upon the uncertain conclusions of financial studies or other material prepared in contemplation of litigation. Relying primarily upon such studies would place the Commission in the undesirable [25] position of substituting its business acumen for that of the acquiring firm, and of ignoring the apparent conclusion of the acquiring firm at the time of the acquisition that both the acquisition and other alternative investments would be more profitable and otherwise sensible than independent entry.

Determining whether a firm had in fact decided to enter independently, and would have done so but for the merger or acquisition at issue, is no easy matter because an entry effort requiring substantial expenditures will ordinarily require the approval of several progressively higher levels of corporate management before it can be considered to have been approved. The Penn-Olin joint venture case provides a useful example. Pennsalt Chemicals Corporation and Olin Mathieson Chemical Corporation formed a joint venture (Penn-Olin Chemical Company) for the production and sale of sodium chlorate in the southeastern United States. The Justice Department challenged the formation of that joint venture. The district court extensively considered the procedures by which each of the two corporations decided whether or not to undertake capital investments.[43] It noted that in the case of Olin, for example, each division annually presented capital expenditure proposals to [26] corporate staff; the staff then evaluated these proposals. The ones they recommended were in turn forwarded to the "Capital Appropriation Requirements Committee;" any proposals they in turn recommended were then forwarded to the president for signature. Capital expenditures greater than $25,000 had to be approved finally by the Board of Directors.[44] In its 1959 report the Chemicals Division had recommended the construction of a chlorate plant, but that recommendation had been rejected by senior management, who ultimately decided to enter into the joint venture instead.[45] The evidence that the Division proposal had been carefully considered internally and then rejected helped to lead the district court to conclude that Olin would not have entered independently.[46]

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[42] *See, e.g., Mercantile Texas Corp. v. Board of Governors of Federal Reserve System*, 638 F.2d at 1269 ("Internal office memoranda could furnish a sufficient basis for inferring intent [to enter independently]"). By contrast, financial studies prepared by an acquiring firm in contemplation of litigation are likely to be less useful because of their presumed recognition that interest in independent entry may strengthen the antitrust case against an acquisition. However, such studies may certainly be used to corroborate or dispute the conclusions that one may draw from internal pre-acquisition studies.

[43] *United States v. Penn-Olin Chemical Co.*, 246 F.Supp. 917 (D. Del. 1965). The district court had initially dismissed the complaint, but on appeal the Supreme Court vacated the judgment and remanded with the directive that the district court should determine whether it was reasonably probable that "either one of the corporations would have entered the market by building a plant, while the other would have remained a significant potential competitor." *United States v. Penn-Olin Chemical Co.*, 217 F.Supp. 110 (D. Del. 1963), *rev'd and remanded*, 378 U.S. 158, 175–76 (1964).

[44] *United States v. Penn-Olin Chemical Co.*, 246 F.Supp. at 919–20.

Recent Commission cases provide additional guidance as to the sorts of evidence that can be relied upon to determine whether independent entry would have occurred. In *Brunswick Corp.,* the Commission concluded that the record was "unusually clear" that Yamaha would have entered the United States outboard motor market "if the joint venture [with Brunswick] had been unavailable to it."[47] The Commission noted that Yamaha had tried to enter the United States market twice before the creation of [27] the joint venture.[48] Moreover, Yamaha had developed extensive plans for the production of several different outboard motors designed expressly for export to the United States, and planned to begin production of at least one of these motors in January, 1973, only two months after the joint venture ultimately became effective.[49] In short, as the Commission indicated, "Yamaha had concrete plans to enter the market by 1973, abandoned only when the joint venture alternative arose."[50] Furthermore, Yamaha possessed the capability to enter successfully; it planned production of a full line of high quality low and high horsepower motors, and its management was experienced both in producing and marketing outboard motors, and in marketing motorcycles and snowmobiles in the United States.[51] The Court of Appeals sustained these conclusions.[52]

By contrast, the *Tenneco* case (addressing Tenneco's acquisition of Monroe) provides an illustration of the sort of evidence that will *not* suffice to show that an acquiring firm [28] would have entered independently.[53] The Court noted that Tenneco had both the interest and the incentive to enter the market for replacement shock absorbers, given (1) the complementarity between its exhaust system products line and shock absorbers identified in internal company documents; (2) Tenneco's acquisition of a small manufacturer with a patent on a new shock absorber design; (3) Tenneco's "adequate financial resources;" and (4) Tenneco's active consideration of entry throughout the late 1960s and early 1970s.[54] However, the Court noted that Tenneco had decided not to enter during that period, despite high profitability in the target market, because it anticipated inadequate earnings during the first few years following entry. The Court found no evidence to support the Commission's conclusion that Tenneco *would* have entered the market later (in 1977, when it acquired Monroe) when market earnings were much lower.[55] The Court also noted that Tenneco had unsuccessfully negotiated to make a toehold acquisition in the market.[56]

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[45] *Id.* at 923–24.

[46] *Id.* at 926–27; *see also United States v. Siemens Corp.,* 621 F.2d at 508; *FTC v. Atlantic Richfield,* 549 F.2d at 296–97 and n. 9.

[47] *Brunswick Corp.,* 94 F.T.C. at 1269.

[48] *Id.*

[49] *Id.* at 1208–15 (Initial Decision), 1262.

[50] *Id.* at 1269. Of course, the fact that Yamaha ultimately chose to participate in a *joint* entry effort supports the conclusion that it found *de novo* entry, at least with the help of another firm, to be economically attractive. That support is of course not available when, as here, the ultimate decision was instead to acquire an incumbent firm.

[51] *Id.* at 1269–71.

[52] *Yamaha Motor Co., Ltd. v. FTC,* 657 F.2d at 978–79.

[53] *Tenneco, Inc. v. FTC,* 689 F.2d 346 (2d Cir. 1982).

These cases suggest that establishing a likelihood of independent entry but for the merger or acquisition at issue requires proof of concrete internal plans for independent entry that have been at least tacitly approved at the governing levels of corporate management. Internal plans that have not been approved at that [29] level cannot be relied upon, regardless of how enthusiastically they promote independent entry, because they cannot be characterized as the concrete plans of the corporation itself.

III. THE APPLICATION OF THESE PRINCIPLES TO THIS CASE

A. *Relevant Markets*

A merger or acquisition that threatens actual potential competition may do so either because it is a *product* extension merger, in which one firm acquires another firm selling related or complementary products, or because it is a *geographic* extension merger, which involves firms selling the same products in different geographic areas.[57] As these characterizations suggest, product and geographic market definitions are crucially important to determining whether a particular merger or acquisition is simply horizontal and therefore governed by an actual competition theory, or instead subject to a potential competition theory. For example, consider two merging firms that produce the same product, one solely within the United States, and the other solely within the United Kingdom. If the relevant geographic market includes both the United States and the United Kingdom, then the two firms are horizontal competitors. If, on the other hand, the United States and the United Kingdom are separate geographic markets, then liability can be established only by considering, absent the merger, the potential for competition between the two firms. [30]

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[54] *Id.* at 353.

[55] *Id.* at 354.

[56] *Id.*

[57] *See United States v. Atlantic Richfield Co.*, 297 F.Supp. 1061, 1069 (S.D.N.Y. 1969), *aff'd mem. sub nom. Bartlett v. United States*, 401 U.S. 986 (1971) (geographic market extension); *Grand Union Co.*, 3 Trade Reg. Rep. (CCH) ¶22,050 (July 18, 1963).

1. Relevant Geographic Market

The ALJ and the parties agree that the United States represents the relevant geographic market in this case. IDF 35; CAB at 7. The record evidence supports that conclusion.

2. Relevent Product Market

Multi-part business forms ("MPBF") are pre-printed documents used to record business data on several sheets of paper simultaneously. They are made almost exclusively from CCP or from bond paper interleaved with carbonized tissue; the latter product is known as "one-time-carbon" ("OTC") because the carbonized tissues are discarded after a single use. IDF 16–19 and n.32. However, the record indicates that CCP should be treated as the relevant product market in this case, separate and distinct from OTC.

As the Commission has previously indicated, reliable measures of supply and demand elasticities provide the most accurate estimates of relevant markets.[58] Unfortunately, the econometric evidence in the record on this issue—an analysis of Appleton's own elasticity, the CCP industry's elasticity, and the cross-elasticity of demand between CCP and OTC prepared for B.A.T by Dr. William Baumol—is not as useful as it might have been. To conduct his analysis, Baumol assumed that CCP buyers decide whether to switch between CCP and OTC between four and six months after a price change is announced. However, the record does not contain any evidence to support that assumption. IDF 34. [31] Moreover, if lags of zero, one, two, or three months are assumed instead, Baumol's data generate cross-elasticities that are not significantly different (in the statistical sense) from zero. Complaint counsel's econometrician, Dr. Ira Horowitz, used Baumol's annual regressions to produce a cross-elasticity coefficient of -0.01, and he testified that there was no significant cross price elasticity between CCP and OTC.[59] These estimates are consistent with a number of prelitigation estimates of Appleton's own elasticity—which should exceed cross price elasticity with more distant products such as OTC—and of cross price elasticity that were similarly not statistically significantly different from zero.[60] Given these conflicting estimates and the problems with Baumol's lag assumptions, his estimate that the cross-elasticity of demand between CCP and OTC is 4.19 cannot be accepted. Respondents have not attempted to rehabilitate the Baumol models on appeal.

In the absence of adequate elasticity measurements, the Commission has indicated that a number of surrogates can be considered. On the demand side, the crucial question is whether a small change in the price of CCP would generate a significant and like-signed change in the quantity of OTC demanded, and vice-**[32]**versa.[61] Approximately 70 percent of CCP production is sold in rolls to MPBF printers who use it to make both unit sets (which can be torn individually from a glued stub) and continuous forms (which are perforated, so that many forms can be filled out sequentially). IDF 26. These printers can use either CCP or OTC in most applications. However, a substantially and persistently higher price for CCP than for OTC (20 to 30 percent higher in 1982)—attributable largely to the greater cleanliness and convenience associated with CCP—indicates that a small price change for either product would be unlikely to induce MPBF printers to switch to the other product.[62]

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[58] *ITT Continental Baking Co.*, ¶22,186 at 23,085; *Grand Union Co.*, ¶22,050 at 22,702–03.

[59] Horowitz, Tr. 1518; IDF 34, *citing* CX 432, 433, 450.

[60] *See* Baumol, Tr. 6147–49, 6365–70, 6497; IDF 34; CX 372; CX 417; CX 450; CX 454.

The remaining 30 percent of CCP production is sold in the form of sheets rather than rolls to paper merchants, who sell the sheets in turn to commercial printers or to company in-plant printing facilities. These buyers cannot switch from CCP to OTC because interleaving carbon sheets and form paper and gluing them together are labor-intensive, time-consuming, and require special equipment. IDF 27–28 and n.43. In conjunction with the other evidence noted above, this factor indicates that the cross-elasticity of demand between CCP and OTC is quite low. **[33]**

On the supply side, the key question is whether a small change in the price of CCP would generate a significant and opposite-signed change in the quantity of OTC supplied, and vice-versa.[63] The record supports the conclusion of Wiggins managers that CCP "is easily the most complex product which is made in high volume in the paper industry." IDF 22. Manufacturing CCP requires unique facilties, custom-designed equipment, specialized raw materials, specially trained personnel, extensive research efforts, and rigorous quality control and testing procedures. IDF 22–24. These highly specialized and expensive facilities cannot economically be used to produce OTC, and there is no evidence that OTC manufacturing facilities can be used to produce CCP. IDF 25 and n.40. In short, the cross-elasticity of supply between CCP and OTC also appears to be quite low.

Record evidence concerning industry perceptions confirms the foregoing conclusions. B.A.T analyzed the Appleton acquisition by treating CCP production alone as the relevant market, and Appleton and other U.S. producers treat CCP as a separate market in developing business strategy and "assessing their competitive strength." IDF 21. CCP production therefore appears to be the relevant product market.

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[61] *ITT Continental Baking Co.*, 3 Trade Reg. Rep. (CCH) ¶22,188 (July 25, 1984), at 23,086 n.54.

[62] IDF 29–33. Dr. H. F. Rance, the "father" of Wiggins' CCP business, observed that even with a thirty percent higher price, CCP could still increase its sales relative to OTC sales by roughly one percent per year. IDF 31; CX 12Z–25. During the 1972–1979 period, CCP sales grew at an average annual rate of 17%, while forms bond and carbonizing tissue grew at rates of only 9% and 4% respectively. IDF 33 n.50.

[63] *ITT Continental Baking Co.*, ¶22,188 at 23,087.

B. *Concentration Levels*

The United States CCP market is highly concentrated. Respondents admit that in 1977, Appleton alone accounted for 53 percent of domestic CCP sales and 56 percent of domestic CCP [34] production; Appleton and Mead, the second largest domestic producer, together accounted for 82 percent of domestic CCP sales and 81 percent of domestic CCP production; and 3M and Nashua together accounted for only 10 percent of the market. IDF 48. The Herfindahl-Hirschman Index ("HHI") in the United States CCP market ranged from 3946 to 4789 between 1975 and 1980. That figure is of course far above the 1800 HHI level that the Justice Department has chosen to rely upon in actual potential competition cases.[64] As the following tables indicate, these market values remained relatively constant during the 1975–1980 period: [35]

Table 1

United States Producers' Share of CCP Resale Market in Percent of Total Tons[65]

	1975	1976	1977	1978	1979	1980
Total Tons	219,500	254,000	277,000[66]	334,000	359,000	389,000
Appleton	57.0	60.0	61.0	64.0	64.0	62.0
Mead	23.0	26.0	26.0	25.0	25.0	26.0
3M	11.0	9.0	8.3	6.9	6.1	5.7
Nashua	7.3	4.0	4.3	4.5	4.5	4.4
Boise	0	0	0	.3	0	1.3
Champion	2.0	1.0	0	0	0	0
Frye	0	0	0	0	.3	.5

Table 2

Leading Firm Concentration in CCP Resale Market (Percent)[67]

	1975	1976	1977	1978	1979	1980
Top 2 Firms	80.0	86.0	87.0	89.0	89.0	88.0
Top 4 firms	98.3	99.0	100.0	100.0	99.6	98.1
Top 8 firms	100.0	100.0	100.0	100.0	100.0	100.0

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[64] The Justice Department will probably not challenge actual or perceived potential competition mergers or acquisitions unless the HHI in the acquired firm's market exceeds 1800. *DOJ Guidelines, supra* note 7, at S–9.

[65] IDF 49, *citing* CX 329A. Although the 1977 shares for Appleton, Mead, 3M and Nashua differ slightly from those to which respondents admitted, the ALJ concluded that these data were consistent with respondents' admissions and provide "an adequately reliable picture of the CCP resale market . . ." IDF 49.

[66] In 1977, these sales were worth approximately $300 million. IDF 49 n.104, *citing* RX 166.

[67] IDF 50.

Table 3
Herfindahl-Hirschman Index (HHI) of Concentration in CCP Resale Market[68]

	1975	1976	1977	1978	1979	1980
HHI	3946	4374	4484	4789	4778	4573 [36]

These data do not include the substantial quantities of CCP that Moore Corporation, the world's largest forms printer, produced solely for its own internal consumption. In 1981, Moore produced 105,000 tons of CCP for its own use, making it the second largest domestic CCP manufacturer when both production for resale and captive production are included. Captive production should ordinarily be treated as part of the relevant product market in merger cases when, as the Justice Department has suggested, a "small but significant and nontransitory" price increase is likely to induce vertically integrated firms to increase production of the relevant product, either for outside sales or to increase their own downstream sales.[69] The record evidence on the issue in this case is mixed. On the one hand, Moore is the only forms manufacturer that has thus far been able to develop an economically viable in-house CCP coating process. IDF 46 and n.97. Moreover, Moore has never sold CCP to forms printers and apparently does not intend to do so. IDF 42, 47. Consistent with these facts, the chairman of Wiggins testified that production for resale and production for in-house use were very different situations, and that he did not consider Moore to be a competitor of Wiggins. IDF 47. On the other hand, Moore's in-house CCP production may nevertheless constrain CCP resale prices to some degree. If buyers from Appleton or other resale manufacturers cannot secure prices that are competitive relative [37] to Moore's internal costs, their downstream sales of business forms in competition with Moore will suffer. We therefore cannot conclude, unlike the ALJ, that Moore's captive CCP production should definitely not be included in the relevant product market. However, it is not necessary to resolve the captive production issue in this case. Even if Moore's internal production were included, and all of the CCP that Appleton produces for Moore were attributed to Moore rather than to Appleton, at the time of the acquisition Appleton still accounted for 48.7 percent of the market; the four-firm concentration ratio was 95.3 percent; and the Herfindahl-Hirschman Index was 4336.[70] [38]

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[68] IDF 51.

[69] *DOJ Guidelines*, *supra* note 7, at S–3.

[70] IDF 50 n.105, *citing* RX 251 (*in camera*), CX 329B. Record evidence other than the foregoing data does not rebut the *prima facie* inference that the concentration requirement of the actual potential competition doctrine has been satisfied. *See* IDF 54–60, 63 for a discussion of that evidence. We disagree with one element of the ALJ's appraisal, however. The ALJ cites Appleton's high accounting profits relative to those of most of the paper industry as evidence of poor competitive performance. IDF 61. However, accounting profits may diverge quite significantly

(footnote cont'd)

C. *Barriers to Entry*

The record evidence indicates that the costs associated with and time required for entry into the United States CCP market are substantial. It is extremely difficult to manufacture CCP, and the ALJ chronicles the consequently limited or completely failed entry efforts of a number of large firms. IDF 36–37, 39–40, 44–46, 74 n.153. The ALJ concluded that developing a viable CCP manufacturing process "requires years of extraordinary effort with no guarantee that at the end of this long lead-time a quality product will be produced at an acceptable cost." IDF 74; *see* IDF 72. For example, Champion spent an estimated $8 million-$10 million on CCP research and development, but could not enter successfully. IDF 79. Required capital expenditures are large in an absolute sense; in 1979, a facility capable of producing 60,000 tons annually (with emulsion plant, coaters, converting equipment, and warehouse facilities, but *without* a base paper facility) would have cost $50 million to construct. IDF 79. Moreover, because CCP equipment is highly specialized and cannot be converted to other uses economically, much of the investment in such facilities represents a sunk cost. IDF 79. Furthermore, a prospective new entrant into the United States CCP market must develop a distribution system. Because of high inventory costs, some established merchants will not carry more than one brand of CCP, and others will not want to risk alienating Appleton, the dominant firm in the United States market, by switching to another brand or beginning to carry more than one brand. IDF 84. Finally, because developing the process [39] is so difficult, only Mead and Wiggins—firms that have entered into licensing arrangements with NCR and therefore have secured the fruits of NCR's and Appleton's experience, technological capability, and know-how—have been able to develop economically viable CCP manufacturing processes.[71] In 1972, the key NCR patents covering the encapsulation process—in which dyes and solvents are encapsuled for later application to the base paper—expired. IDF 73. Nevertheless, Appleton continued to hold a variety of valid patents on a number of related manufacturing processes, and as some patents expired it obtained new ones. Even though many of these latter patents offered only "dubious protection," they nevertheless continued to

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from real economic profits, and their utility for evaluating competitive performance is therefore limited. *See, e.g.*, Fisher and McGowan, *On the Misuse of Accounting Rates of Return to Infer Monopoly Profits*, 73 Amer. Econ. Rev. 82 (1983).

For a discussion of the significance of structural, behavioral, and performance factors in evaluating the state of competition in a given market and the likelihood that a collusive strategy could succeed, *see* Clark, *Price Fixing Without Collusion: An Antitrust Analysis Of Facilitating Practices After Ethyl Corp.*, 1983 Wis. L. Rev. 887, 891-906 (1983).

[71] IDF 10, 69 and n. 138, 86–87, *citing* Sheehy, Tr. 3561, CX 142J, CX 48D *(in camera)*.

inhibit entry into the United States CCP market to some degree. IDF 73.

D. *Number of Firms Capable of Entry*

As the foregoing discussion suggests, the difficulty of mastering the coating technology and the prospect of running afoul of one or more Appleton patents substantially limited the number of prospective entrants into the United States CCP market at the time of the Appleton acquisition. IDF 86. Respondents argue that a number of paper companies were "as likely" as B.A.T to enter independently at that time. RAB at 55–58. However, among U.S. paper companies, which can of course supply base paper internally, only Mead had successfully entered, and that followed a close seventeen year relationship with Appleton. Several other large paper companies, including Boise Cascade, Champion, and [40] Crown Zellerbach, had been unable to acquire more than very small shares of the U.S. market.[72] Appleton's two Japanese CCP licensees—Jujo and Mitsubishi—were barred from entering until 1985 at the earliest under the terms of a 1977 licensing agreement. IDF 87. A third manufacturer, Fuji, had a licensing agreement with Mead under which Mead acquired the exclusive right to manufacture and sell CCP in the United States using the Fuji technology, to the exclusion of Fuji.[73] European firms were similarly unlikely to enter. In 1977, Wiggins accounted for 45.4 percent of all European sales; its closest competitors accounted for only 6.3 percent and 5.9 percent of European sales respectively, and they were barred from entering the United States because they were Fuji licensees, and hence subject to the Fuji-Mead restrictions. The other European manufacturers were so small that even if they had been able to enter the U.S. market, their entries would probably not have had a very significant competitive effect. IDF 90–91. Finally, there is no evidence that Moore or any other business form printer contemplated entering the U.S. resale market at the time of the acquisition. IDF 92. [41]

E. *Competitive Benefits from Independent Entry*

The record evidence establishes that if B.A.T had entered the United States CCP market independently, that sort of entry might have substantially improved competition conditions in that market. Despite Wiggins' large share of European CCP sales, the entry of Japanese firms into that market since 1972 has substantially increased price and quality competition.[74] Appleton recognized that new competition in the United States from abroad would have similar effects in that market; it "would have to be met competitively on quality and price in the marketplace."[75] B.A.T believed that Appleton's power to impose price leadership and price "stability" on the CCP market would decline if its large market share were eroded by, for example, new entry.[76] However, we need not determine whether independent entry by Wiggins would have improved competitive conditions—and whether the competitive benefits from that sort of entry would have outweighed the competitive benefits associated with Wiggins' acquisition of Appleton—because of our conclusion that the record evidence is not sufficient to constitute clear proof that Wiggins would have entered the United States CCP market independently if it had not acquired Appleton. We now discuss the support for that conclusion. [42]

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[72] IDF 86; *see* Table 1, *supra*.

[73] IDF 88. This arrangement apparently also prevented a fourth Japanese firm, Kanzaki, from selling CCP in the United States. IDF 89.

[74] IDF 97; Best, Tr. 2405, 2407–08.

F. *Likelihood That B.A.T Would Have Entered Independently*

Determining whether a respondent would have entered independently absent the acquisition at issue requires an assessment of its financial and managerial capabilities, interests, and incentives. That assessment is complicated in this case because the complaint alleges only that B.A.T was an *actual* potential entrant (not a *perceived* potential entrant) and therefore implies that incumbent firms did *not* perceive B.A.T to be a likely entrant; the record evidence confirms that implication. An effort to establish that B.A.T would have entered the market independently must consequently contradict and overcome the perceptions of the incumbent firms that presumably are the most knowledgeable in the business.

B.A.T arguably possessed the capability to enter the United States CCP market in an alternative fashion, such as by constructing a "greenfield" plant in the United States, or by exporting CCP from Europe. However, a number of obstacles stood in its way. The first obstacle was Wiggin's licensing arrangement with NCR, under which it was permitted to use certain Appleton CCP technologies. The license gave Wiggins the exclusive right to manufacture CCP in Western Europe, most of the British Commonwealth, and other countries but not in Japan, Canada or the United States. It also gave Wiggins the non-exclusive right to sell CCP worldwide, except in Canada and the United States. RX 12. However, as we note *infra,* in 1976 Wiggins began negotiating to secure an extension of the licensing agreement that would have for the first time permitted it to use [43] Appleton's patents and knowhow to market resin-based CCP in the United States after June 30, 1980.[77] Wiggins' experience under its earlier license, including its familiarity with Appleton's techniques, probably would have helped it to produce resin-based CCP in this country. Although there are some differences between clay-based and resin-based CCP technologies, most of the technological processes are similar, and most experienced CCP firms can switch from clay to resin. IDF 76.

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[75] CX 100Q; *see* IDF 96 and n.208.

[76] IDF 96; RX 16Z–1.

[77] By 1977 NCR had concluded that it could no longer keep Wiggins out of the United States simply by asserting a patent block of dubious validity, and therefore was apparently willing to permit Wiggins to produce CCP under license in the United States. IDF 76 n.155.

The second obstacle related to patent coverage. Although the key NCR patents covering encapsulation had expired in 1972, Appleton continued to hold a large number of CCP patents, and continually added new ones as old ones expired.[78] Nevertheless, Wiggins' CCP mentor, Dr. Rance, did not believe that the Appleton patents would be a major deterrent to entry.[79] Wiggins' "Idem" technology relied upon clay-based reactants to produce CCP, and both Wiggins and Appleton believed that by 1980 Wiggins would be able to produce the Idem brand of CCP in the United States without infringing any NCR patents. IDF 77. In short, Wiggins clearly possessed the technological *capability* to produce Idem in the United States if it had wished to do so. **[44]**

Securing an assured paper supply represented a third potential obstacle to independent entry by Wiggins. The most secure way to assure such a supply would of course have been to integrate backward into paper production, and that is the course that Wiggins had followed in all of its markets. Long-term supply contracts represented an alternative, however, and the record evidence does suggest "that assured sources of paper are readily available." IDF 83. Of course, as we have noted *infra*, purchasing base paper is considerably more expensive than producing it internally. Establishing a paper merchant distribution system represented a fourth potential difficulty, given the apparent reluctance of many merchants to carry more than one brand of CCP, or to switch to a new brand without a substantial discount. IDF 84. Finally, Wiggins could not have entered independently sooner than two to four years after B.A.T acquired Appleton. Its licensing agreement with Appleton would have expired on June 30, 1980. IDF 94. Wiggins believed that "it would take two to four years to plan and construct a new coating operation."[80]

These five types of obstacles would have made it more difficult for Wiggins to enter the United States CCP market independently. The record evidence nevertheless indicates that Wiggins possessed the financial, technical, and managerial capability to overcome them. B.A.T's substantial financial resources would have been particularly helpful. B.A.T could afford to pay NCR $300 million for Appleton, and we can therefore **[45]** assume that it could also have afforded to invest the $175–$200 million needed to construct a greenfield coating plant and an integrated base paper production facility, as well as any additional funds needed to set up a distribution system.[81]

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[78] IDF 73, *quoting* CX 343A (a Wiggins planning officer).

[79] IDF 73 n.151; CX 194E.

[80] IDF 94 n.205, *citing* CX 150A *(in camera)*, 241H *(in camera)*, RX 121Z–45 *(in camera)*.

The record evidence also indicates that B.A.T was interested in entering the United States CCP market. B.A.T considered the United States to be a high priority investment area as of 1978, and its investment strategy reflected that view; in 1977, for example, it devoted 32 percent of its total capital expenditures to United States investments, more than in any other country.[82] B.A.T's acquisition of Germaine Monteil, Gimbel Brothers, Saks Fifth Avenue, and Marshall Field, among others, as well as its operation of the Brown & Williamson Tobacco Corporation, certainly suggest that it has had a sustained interest in the United States as an important area for investment. *See* IDF 4. More parochially, Wiggins considered the United States to be its most likely territory for expansion, because of its large [46] absolute size (it accounts for almost half of the world's CCP tonnage) and its substantial growth potential (greater than other geographic areas).[83]

The principal difficulty with the foregoing evidence is that it simply establishes that B.A.T possessed the capability to enter and an interest in entering the United States CCP market. It does not establish that independent entry would have been *sufficiently* attractive to induce B.A.T to enter the market independently but for its acquisition of Appleton. The Commission must establish that B.A.T had sufficiently strong economic incentives to enter the United States CCP market independently, rather than through the acquisition of a leading firm, so that if the acquisition had been prevented, it *clearly* would have entered the market in some other fashion.[84]

The record evidence does not satisfy this burden. At the time of the Appleton acquisition the United States CCP market was profitable; it consisted of a limited number of competitors insulated by substantial entry costs; it was growing relatively rapidly; and Wiggins had both the interest and the capability needed to enter. However, the crux of this case amounts to whether Wiggins would have found it profitable to enter independently, and planned to do so. General circumstantial evidence, including in particular non-public documentary evidence not prepared in contemplation of litigation, provides the best [47] picture of whether an acquiring firm would have entered independently but for its acquisition. As complaint counsel correctly point out, financial model evidence prepared in contemplation of litigation ordinarily should be relied upon only to corroborate or dispute conclusions drawn from that sort of more general evidence. CAB at 18–22. We will discuss both types of record evidence in the following sections.

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[81] IDF 80, 81 113; *see* CPF 194 *(in camera)*; CX 206I. B.A.T argues that the prospect of in-house coating by forms printers discouraged independent entry, but one would expect that prospect to discourage a $300 million investment to purchase Appleton to an even greater degree. IDF 81. Moreover, both B.A.T and Appleton believed that scale considerations and development costs would confine in-house coating to Moore, and knew that Moore had historically produced OTC rather than CCP for its business forms. IDF 81.

[82] IDF 64; Sheehy, Tr. 3465–67; CX 49C.

[83] IDF 65–67; CX 45C; CX 128A; CX 257Z–62; CX 192F.

[84] *Grand Union Co.*, ¶22,050 at 22,715.

1. Independent Entry by Exporting CCP from Europe

The record evidence indicates that exporting CCP from the United Kingdom to the United States would not have been economically feasible, and complaint counsel have now abandoned that argument. IDF 124 and n. 323; *see* 324–33. It is not clear that Wiggins' clay-based Idem could have been manufactured and sold in the United States in a cost-effective fashion. Although Idem is apparently a better quality CCP than Appleton's resin-based CCP, and is "less vulnerable to attacks on toxicological, ecological, and environmental grounds," it is more expensive than Appleton's CCP because of higher production costs.[85] Wiggins had therefore concluded that the North American market was not available to W.T. exports (RX 79; CX 54A), and complaint counsel's expert conceded that entry into the United States market with Idem, as it is formulated in the United Kingdom, would not have been competitive. IDF 78; Horowitz, Tr. 1607–08. [48]

2. Independent Entry by Securing A Nonexclusive License from NCR

The only completely independent alternative to exporting Idem that is discussed in the record would have been to set up production facilities in the United States, under license from NCR.[86] However, a "greenfield" entry effort of that sort would have been inconsistent with B.A.T's corporate policy to prefer the "flying start" from acquiring firms "with a quality position in the [target] market" to greenfields investments.[87] In the 1970s, B.A.T's new investments in the United States all involved the acquisition of "industry leader[s]." Sheehy, Tr. 3517–18. Moreover, B.A.T ordinarily required new Wiggins operations to reach or maintain a significant market share within five years after entry, and even complaint counsel's models projected a share from *de novo* entry no greater than 6.7 percent during the first five years, and never greater than 9 percent.[88]

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[85] IDF 78. Wiggins' European CCP prices have consistently exceeded United States CCP prices by 25%–40%. RPF 304. During the trial, complaint counsel acknowledged that B.A.T's product "is apparently not the product that the U.S. buyers are willing to pay more money for . . ." Newborn, Tr. 6895–96; IDF 78 n.164.

[86] There is some question whether entry under license should be characterized as independent entry, because the terms of the license can importantly affect the competitive significance of the licensee. One might in fact argue that such an entry effort will ordinarily not produce the prospective procompetitive effects that the actual potential competition doctrine requires, because the licensor could make the royalty charges high enough to prevent the new entrant from offering lower prices than incumbent firms.

[87] RX 60A, 60F; RPF 265–66; RRF 162–65; Sheehy, Tr. 3495–96, 3512–13.

The record evidence concerning B.A.T's internal calculations confirms the validity of these conclusions. The respondents argue that [49]

> B.A.T did not draw up plans to enter, did not conduct surveys of the market in anticipation of entry, [and did not] budget even a shilling to consider entry.

RAB at 42; *accord*, RPF 242–51. Complaint counsel admit that B.A.T did not produce any "comprehensive written plan to enter the U.S. market" prior to its acquisition of Appleton. CRF 197. It is true that in 1976 and 1977 Wiggins and NCR discussed an extension of their licensing agreement—due to expire in 1980—that would have permitted Wiggins to sell CCP produced under license from NCR in the United States.[89] In September, 1977 Wiggins formally proposed a five-year extension under which it would have been able to manufacture and sell CCP in the United States after June 30, 1980. In response, NCR offered to license Wiggins nonexclusively to produce and sell CCP worldwide, in exchange for a royalty equal to one percent of sales.[90] However, Wiggins did not agree to these terms, but instead offered to pay a royalty equal to one-half of one percent of sales in exchange for the license. At the same time, Wiggins became aware that Appleton might be available for acquisition, and the licensing negotiations therefore ended before a final agreement had been reached.[91] **[50]**

As we noted above, the best evidence of B.A.T's intention to enter independently would be internal, concrete capital investment plans that both were *not* prepared in contemplation of litigation and were *not* available to incumbent firms. However, the ALJ concluded that no contemporaneous documents from respondents' files indicated that B.A.T had in fact concluded that independent entry would have been attractive. ID at 120–21, 125–26. The only real evidence from internal documents relates to the licensing negotiations, which could be characterized as an affirmative step toward entry. IDF 70. However, a variety of additional obstacles, described more fully in the discussion of the financial models *infra*, suggest that that sort of independent entry would have been unlikely.

The absence of internal, non-public, and contemporaneous documentary evidence that B.A.T intended to enter independently compares favorably with the testimony of witnesses representing downstream form printers (SCM, Burroughs, and Uarco, among others) and competing firms (Mead, 3M, and NCR) that independent entry by B.A.T into the United States CCP market, to compete with strongly entrenched incumbents like Appleton and Mead, would not have made any economic sense.[92] In short, the "non-model" **[51]** evidence in the record simply does not provide clear proof that Wiggins would have entered independently but for its acquisition of Appleton.

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[88] IDF 112; CX 260; RPF 272.

[89] IDF 70; CX 114B; Best, Tr. 2697.

[90] CX 114; CX 117; CX 120.

[91] IDF 70. One reason that negotiations ended may have been the fact that B.A.T's lawyers advised that further negotiations would undercut B.A.T's argument that it could practicably enter only via acquisition. *See* IDF 70; CX47H. However, the fact that B.A.T decided to purchase Appleton certainly obviated, in any event, further discussions of licensing arrangements.

The financial model evidence does not contradict this conclusion. Complaint counsel have presented a number of financial studies that purport to show that independent entry pursuant to a license from Appleton for its resin-based CCP technology would have been profitable, while respondents have presented other studies that purport to show that it would not have been profitable. As we have already indicated, studies of this sort that are prepared for or in contemplation of litigation will ordinarily be useful only to corroborate or refute the conclusions to be drawn from contemporaneous internal studies.

We will begin by determining whether the studies proferred by complaint counsel suggest that independent entry by Wiggins would have been profitable. The principal study (CX 260), prepared by Dr. Ira Horowitz, assumes that Wiggins would have entered the United States market by constructing a United States facility to produce resin-based CCP (with production to begin in 1981), would have paid Appleton a one-percent royalty for the use of its resin-based technology, would *not* have integrated backward into base paper production, and would have sold CCP at a 3 percent discount that incumbent firms would *not* have matched and that would have been sufficient to sustain an annual rate of growth, once established, of 15 percent. With these assumptions, Horowitz calculated the present value of all expected net cash receipts from *de novo* entry of this sort, discounted by the **[52]** marginal cost of capital, and from that calculated B.A.T's rate of return from such an investment. IDF 102. Horowitz determined that B.A.T would have earned an internal rate of return of 14 percent if it had financed the entire investment with internal funds ("without debt"), and an internal rate of return of 17.9 percent if it had financed 38.5 percent of the investment through borrowing at an annual interest rate of ten percent ("with debt").[93] This result assumes a manufacturing cost of $875/ton, "other expenses" of 12.5 percent of net revenue, and a selling price of $1232/ton.[94] If the manufacturing cost had been raised to $975/ton (to account for additional costs attributable to nonintegration into base paper production) (*see* note 101 *infra*), and all the other assumptions had been retained, then Horowitz' calculated rate of return would have fallen to 7.8 percent (without debt). IDF 103 n.224.

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[92] P. Smith (Mead forms paper division president), Tr. 1031; Roth (SCM forms printing division president), Tr. 1760–61; Reeves (Standard Register Co. forms printer), Tr. 816–17; Ramey (3M CCP operations manager), Tr. 3849–53; Hummell (Burroughs), Tr. 3994–96; Mustari (Uarco), Tr. 4396; Shade (Shade Information Systems), Tr. 4067–93; Eichner (Reynolds & Reynolds), Tr. 4268–69.

[93] B.A.T ordinarily determined the relative desirability of investments without considering financing techniques. The "without debt" return figures are therefore more probative with respect to divining its investment intentions.

These estimates are highly sensitive to a number of factors. For example, Horowitz estimated that Wiggins' manufacturing costs in the United States would be $875 per ton, approximately the same as Appleton's costs, despite the fact that Appleton has an integrated base paper source that Wiggins would [53] not have had, and purchasing paper is more expensive than manufacturing it.[95] Although adding a base paper production machine would dramatically increase the cost of *de novo* entry (by $125 million-$150 million, assuming a CCP volume of 67,000 tons), most industry members testified that non-integrated entry would not be economically feasible.[96] Wiggins officials apparently believed that their European CCP success was directly related to the integrated nature of their operation, and there is no evidence that Wiggins "investigated the profitability of non-integrated entry." IDF 105. In its 1975–76 analyses, International Paper similarly concluded that "non-integrated CCP facilities could not be cost-competitive," citing cost advantages associated with lower base stock, handling, and packaging costs, and revenues from waste products.[97] Nashua and 3M both felt that their lack of profitability was largely attributable to their lack of integration into base paper production. Mead believed [54] that integration into base paper production was essential to reduce costs and provide better quality control. IDF 105. Horowitz justified his comparable costs assumption by arguing that advantages associated with technologically advanced coating processes (which he assumed that Wiggins as a new entrant would possess) would completely offset the advantages of full integration. IDF 106. However, the ALJ noted that Appleton itself was highly efficient, largely because it could coat on its own paper machines; that it had just recently constructed the most modern CCP plant in the world; and that the record did not provide a basis for presuming, as Horowitz did, that Wiggins as an independent entrant would have been sufficiently more efficient than Appleton to offset Appleton's integration advantage. IDF 106 and n.246.

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[94] IDF 103. The selling price was calculated by substracting a 3 percent discount from Appleton's selling price of $1270 per ton. *Id.* Dr. Horowitz assumed that if B.A.T offered such a discount, it might be able to acquire market share; however, the ALJ considered it unlikely that a 3 percent discount would suffice. IDF 116.

[95] IDF 105. The $875 cost figure represents 69 percent of the selling price of $1270, a rough approximation of Appleton's manufacturing costs, which ranged from 65.3 percent of price in 1973 to 73.5 percent of price in 1980. IDF 105, *citing* Horowitz, Tr. 1433, 1441–43, 1446, 1471–77, 1490–91, 1498–99. Horowitz also assumed that Appleton's integration advantage would be offset by Wiggins' presumed use of "state-of-the-art technology" in its United States coating operation.

[96] IDF 105 and n.230. Respondent's evidence indicates that adding the cost of a paper machine to the Horowitz model, with its assumed annual CCP volume of 67,000 tons, results in steady losses. The ALJ suggests that twice that volume would have to be taken from Appleton and Mead to produce an adequate return on investment in a new integrated operation. IDF 105 n.230.

[97] IDF 105. For example, significant savings can be achieved if base paper can be coated while it is still on the paper-making machine, an option not available to a non-integrated producer. IDF 106.

The assumptions that Wiggins could have secured customers by offering prices only 3 percent below those offered by incumbent firms, and that incumbent firms would not have lowered their prices to prevent customer defections, also seem implausible. Joseph Ramey, a group vice-president at Mead, testified that Mead had had to offer a 20 percent discount to secure a significant share of the United States CCP market.[98] The ALJ considered it unlikely either that Wiggins could secure any appreciable volume on the basis of a 3 percent discount or that Appleton and Mead would permit any significant erosion in their market shares [55] through unanswered price reductions.[99] In addition, it seems unlikely that Appleton, as Wiggins' licensor, would enthusiastically facilitate the entry of a prospectively substantial competitor into its most lucrative CCP market. The weakness of these assumptions severely limits the utility of the Horowitz financial models.

To address the Horowitz model, respondents relied upon Mr. Robert Heitpas, Appleton's assistant controller, to prepare models based upon somewhat different assumptions. IDF 102. In particular, Heitpas assumed that if Wiggins were not integrated, it would suffer from the same base paper purchasing disadvantage that confronted Appleton's non-integrated facilities.[100] Heitpas estimated that that penalty ranged from $113.50 per ton to $151.37 per ton.[101] With all other factors used by Horowitz held constant, these corrections produced internal rate of return [56] estimates of 5.5 percent and 2.3 percent respectively (without debt) and internal rate of return estimates of 5.8 percent and 0.7 percent respectively (with debt).[102]

In response to Heitpas' efforts, complaint counsel relied upon modifications in the Horowitz models prepared by David Painter, chief supervising accountant in the Commission's Bureau of Competition. Painter relied upon Appleton's actual 1977 costs ($902 per ton), added to that a $72.34 per ton base paper penalty,[103] and subtracted three percentage points from the "other expenses" category to account for Appleton's base paper production expenses.[104] With Painter's modifications and with all other factors held constant, the Horowitz model produces internal rate of return estimates of 10.2 percent (without debt) and 12.6 percent (with debt). IDF 103. [57]

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[98] Ramey, Tr. 3835, 3853.

[99] IDF 116, *citing* Horowitz, Tr. 1470, 1506, 1586-87 and Kershaw, Tr. 1320.

[100] Appleton produces about 70 percent of its base paper needs internally. IDF 107.

[101] The first penalty estimate—$113.50 per ton—represents the actual cost advantage of the integrated Appleton, Wisconsin plant in 1977. To apply that figure to a 1981 entry, Heitpas adjusted it to account for inflation and for Appleton's level of integration. IDF 107. The second penalty estimate—$151.37 per ton—represents the cost advantage projected for an expansion of Appleton's Harrisburg, Pennsylvania plant, adjusted to reflect Appleton's anticipated level of integration. IDF 107 and n.249.

[102] IDF 103. Respondents also proferred a number of models prepared by Vera Elliott, a recently retired Wiggins planning officer. IDF 102. The ALJ concluded that these models were unreliable. IDF 119. In light of the conclusions we draw from the Painter models, we need not evaluate the Elliott models.

[103] This figure was derived by adjusting an $85 per ton estimate of the base paper penalty downward to account for inflation and Appleton's overall integration level of 70 percent in 1977. IDF 108. The ALJ criticized the $85

(footnote cont'd)

The extreme sensitivity of the foregoing internal rate of return estimates to even small changes in their underlying assumptions illustrates why models of this sort should be used primarily to corroborate or dispute conclusions based upon internal analyses not prepared in contemplation of litigation. However, the models themselves do not in any event establish that Wiggins would have entered independently but for its acquisition of Appleton. The rates of return produced by the original Horowitz model are not plausible because they assume (1) that Wiggins would have entered on a non-integrated basis, without accounting for the apparently substantial penalties (in the form of higher base paper costs) associated with non-integrated production; and (2) that Wiggins would have been able to secure customers—sufficient, once established, to sustain a 15 percent annual growth rate—by offering only a 3 percent discount without provoking retaliatory price reductions by Appleton and Mead sufficient to prevent any significant shift in market shares. The Painter model provides somewhat more credible internal rate of return estimates because it does account for non-integration penalties, although its assumed value for those penalties is not as well grounded in Appleton's actual experience as the Heitpas penalty estimates. However, it relies upon the unsupported assumption that Wiggins would have saved 3 percent of net revenues in "other expenses" by virtue of *not* integrating backward into base paper production. If "other expenses" were instead held at 12.5 percent, Painter's model might have projected a rate of return as low as 8.5 percent (without [58] debt).[105] Moreover, the Painter model assumes, like the Horowitz model, that Wiggins could capture market share by selling CCP at a price 3 percent lower than Appleton's price. The ALJ found this assumption to be "doubtful," and the record evidence suggests that a 10 percent to 20 percent discount would be required to induce customers to switch from an established firm to a new entrant. IDF 116; RPF 369–76, 380.

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figure as a "rough estimate undefended by Painter as a witness . . ." that was contradicted by the $113.50 and higher estimates in respondents' business records. IDF 109. For a thorough discussion of how the base paper penalty should be calculated, *see* IDF 109.

[104] IDF 108. The ALJ criticized Painter's reduction in the "other expenses" percentage from 12.5 percent to 9.5 percent, characterizing the view that the predicted savings would approach 3 percent of net revenue as "sheer conjecture." IDF 110. The "other expenses" category included, in Appleton's case, "freight, shipping, finished goods warehousing, operations services, marketing, [research and development], finance, and the expenses of the president's office." IDF 110.

[105] *See* CAB at A-1, ¶II.(b). This assumes that the reduction in the 10.9 percent rate of return projected in ¶I (without debt) would be three times as great as the 0.8 percent reduction a percentage point increase in "other expenses" would produce.

Increasing the discount to 10 percent would reduce the Painter model rate of return projection (without debt) to less than 5 percent. RAB at 30.

Furthermore, even if Painter's model is accepted as valid, there is little reason to believe that the rates of return it estimates would have induced Wiggins to enter independently. Wiggins acquired Appleton "on the basis of an estimated discounted cash flow" (without debt) of 10.5 percent over fifteen years. IDF 118. The Painter model provides an internal rate of return (without debt) of only 10.2 percent. As the ALJ points out, while 10.5 percent may be a sufficient rate of return to warrant

> acquiring a relatively risk-free, profitable, and dominant firm, there is no evidence that it is equally attractive for a greenfield venture involving considerable uncertainty. [59]

IDF 118 (citations omitted). B.A.T itself has in the past required a rate of return of at least 15 percent to justify "a greenfield investment in the paper industry."[106] The 10 percent rate of return which the Painter model identifies is actually more consistent with the sort of economic equilibrium that perceived potential entry can create. Of course, the complaint does not allege that B.A.T was a perceived potential entrant, and complaint counsel were therefore foreclosed from pursuing that line of inquiry.

3. Other Forms of Independent Entry

Complaint counsel argue that Wiggins could have entered by establishing a joint venture with another firm. Wiggins apparently did consider setting up a joint venture with International Paper in 1976, but it ultimately rejected the idea, and there is no evidence to establish that such a venture would have been profitable or feasible. IDF 121. As the ALJ points out, since a horizontal joint venture would presumably entail the same sort of investment in new plant and equipment as *de novo* entry, it is unlikely that it would have been any more profitable than *de novo* entry by Wiggins alone. IDF 121. Complaint counsel have also suggested that Wiggins could have entered by licensing its technology to an existing firm. However, if it were licensed to an incumbent firm, it is difficult to see why that would [60] improve competitive conditions. If, alternatively, it were licensed to a new firm, that firm would probably confront even more *de novo* entry problems than Wiggins itself. Finally, there is no evidence that Wiggins considered entering the United States CCP market by making a toehold acquisition of the CCP components of firms such as

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[106] IDF 118, *citing* RX 758H. For example, B.A.T rejected a proposal to convert one of its United Kingdom paper mills to other paper products—a far less risky venture than *de novo* entry—because it did not project an IRR of 15 percent. RX 758; RPF 430.

Nashua, 3M, or Boise. IDF 122. The CCP businesses of Nashua and 3M are not integrated into base paper production, so that if Wiggins had acquired either firm, it would have confronted the same non-integration and inefficient technology problems that both firms confront. IDF 122 and n. 318.

IV. CONCLUSION

Complaint counsel have failed to demonstrate that B.A.T was an actual potential entrant into the United States CCP market. The Commission has therefore determined to dismiss the complaint in this matter in all respects.

COMMISSIONER PATRICIA P. BAILEY, CONCURRING IN B.A.T INDUSTRIES, LTD. AND APPLETON PAPERS, INC.

Is there the opposite of a Pyrrhic victory? If so, it would describe this case, where the Commission's litigation unit has lost the battle but won the war—for the business community as well as themselves. *B.A.T* was intended as a test case to see if purely objective evidence could establish liability under the actual potential entrant theory. The answer today is that it cannot. Despite a well-litigated case which presented us with as extensive and in-depth an economic record as we are likely to see, the inherent limitations of economic evidence mean that, standing alone, it cannot meet a a "clear proof" (or, in my opinion, even a "reasonable probability") standard. Financial models of expected profitability are a complicated web of interrelated assumptions. They can be a useful business planning tool but were never designed to withstand the scrutiny of normal judicial process, which is concerned with demonstrable facts. Models are highly vulnerable to litigation challenge where doubts raised about even one part can invalidate the whole. The clear trend among the courts, which this Commission today joins, is reluctant to undo business transactions on the basis of speculation.

In practice this means that, at the Commission at least, actual potential competition theory is dead. Only "concrete plans" will carry the day, but the more anticompetitive an acquisition is, the less a company is likely to create—or preserve—documents assessing expected returns on other, more legitimate, means of entry. Thus, only those entities who ignore the wisdom of some well known sages[1] need fear the toils of the actual potential competition net. But on the whole this is preferable to wasting resources trying to prove chalkboard speculations. Both our staff and the business community should welcome the certainty this opinion brings.

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[1] See no Evil, Hear no Evil, and especially Speak and Write no Evil.

FINAL ORDER

This matter has been heard by the Commission upon the appeal of complaint counsel from the initial decision and upon briefs and oral argument in support of and in opposition to the appeal. For the reasons stated in the accompanying Opinion, the Commission has determined to affirm the initial decision. Complaint counsel's appeal is denied. Accordingly,

It is ordered, That the complaint be, and it hereby is, dismissed.

Commissioner Azcuenaga did not participate.

IN THE MATTER OF

INTERNATIONAL HARVESTER COMPANY

FINAL ORDER, OPINION, ETC. IN REGARD TO VIOLATION OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Docket 9147. Complaint, Oct. 10, 1980—Final Order Dec. 21, 1984

This Order affirms in part and reverses in part the 1982 Initial Decision of the Administrative Law Judge ("ALJ") and orders that it be adopted as the "Findings of Fact and Conclusions of Law of the Commission, except as is inconsistent with the accompanying Opinion." The ALJ had ruled that a Chicago, Ill. manufacturer of farm machinery had violated Sec. 5 of the FTCA by failing to adequately disclose to consumers that its gasoline-powered tractors were subject to a safety hazard known as "fuel geysering," even though the company knew of the potential danger. While the Commission agreed that the company's failure to disclose the safety risk constituted an unfair trade practice, it ruled that, contrary to the ALJ's finding, the practice could not, as a matter of law, be considered deceptive since there was no representation, practice or omission likely to mislead consumers found in this case. Although the Commission ruled that the manufacturer has violated the FTCA, it upheld the ALJ's decision not to order further remedial action because the company no longer manufactures gasoline-powered tractors and because the company's 1980 voluntary notification program had already provided as much relief as could be expected from a Commission order.

Appearances

For the Commission: *Richard H. Gateley, Michael Milgrom, Rosemary Rosso, Michael L. Sirota* and *Cynthia E. Smith.*

For the respondent: *James R. Fruchterman,* in-house counsel, Chicago, Ill. and *J. Alan Galbraith, Aubrey M. Daniel, III, William E. McDaniels, Carolyn H. Williams* and *Michael S. Sundermeyer, Williams & Connolly,* Wash., D.C.

COMPLAINT

The Federal Trade Commission, having reason to believe that International Harvester Company, respondent, has violated the Federal Trade Commission Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the public interest, issues this complaint.

1. Respondent is a Delaware corporation with its executive offices at 401 North Michigan Avenue, Chicago, Illinois.

2. Respondent is now, and has been, engaged in the design, manu-

facture and marketing of agricultural equipment, including but not limited to tractors.

3. Respondent causes agricultural equipment to be shipped to purchasers in various states and, therefore, maintains, and at all times mentioned in this complaint has maintained, a substantial course of trade in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act. [2]

4. Respondent manufactured approximately 1.6 million gasoline-powered tractors from 1939 through 1975. Such tractors include model numbers such as 300, 350, 400, 450, 600, 656, 706, 756 and 806. The tractors were designed with the fuel tank located in front of the operator above and behind the engine. As many as 800,000 of these tractors may still be in use and be subject to resale by respondent or its dealers.

5. The location, and in some cases the shape, of the fuel tank in such gasoline-powered tractors subjects the tank to fuel heating and vaporization, causing pressure build-up in the fuel tank during normal operation. If the fuel cap is dislodged or removed when the tractor is hot or running, fuel vapors and liquid fuel can shoot or geyser up to 20 feet, spraying the operator or the tractor with gasoline which can, and has, spontaneously ignited. A reasonable likelihood exists that the fuel cap may be dislodged or removed when the tractor is hot or running. In fact, numerous incidents of fuel geysering have occurred on International Harvester tractors. As a result of fuel geysering, some operators of the tractors were severely burned and at least one operator has been killed. In other cases, tractors have exploded as a result of fuel geysering. Fuel geysering, which was not reasonably to be expected by many operators of such tractors, creates a substantial risk of injury or death. Fuel geysering is, therefore, a safety hazard.

6. Beginning in 1955, respondent had information by which it knew, or should have known, that tractors containing fuel tanks located in front of the operator above and behind the engine were subject to fuel geysering due to a pressure build-up in the fuel tanks.

7. Beginning in 1958, if not earlier, respondent determined that a quick release of pressure from the fuel tank, as occurs in removal of the fuel cap, may result in fuel geysering which, in the presence of a hot engine or other means of ignition, can lead to fire.

8. Respondent has failed to disclose adequately the facts concerning the existence of fuel geysering. Respondent has failed to disclose adequately the facts concerning the nature or extent of injuries due to fuel geysering and steps which might be taken to prevent injury or death. Absent adequate disclosures of such facts, some prospective purchasers or some owners or operators of respondent's gasoline-powered tractors have reasonably assumed that fuel geysering does

not occur or that fuel geysering is not a safety hazard. Such facts, if known by many prospective purchasers, would likely affect their considerations of whether to purchase new or used agricultural equipment manufactured by respondent. Such facts, if known by many owners or operators, would likely affect their decisions concerning the use or care of agricultural equipment manufactured by respondent, which could prevent substantial personal or economic injury. Therefore, respondent has failed to disclose material facts. Such failures to disclose constitute deceptive or unfair acts or practices. [3]

9. Respondent's acts and practices in failing to disclose adequately material facts have had, and now have, the capacity and tendency to mislead many members of the public, particularly those who may consider purchasing, or who own or operate, agricultural equipment produced by respondent. Such acts and practices cause and have caused substantial personal or economic harm to many members of the public.

10. Respondent's acts and practices in failing to disclose material facts as alleged herein were and are all to the prejudice and injury of the public and constitute unfair or deceptive acts or practices or unfair methods of competition in or affecting commerce, in violation of Section 5 of the Federal Trade Commission Act, as amended.

STATEMENT OF COMMISSIONER DIXON[*] DISSENTING FROM ISSUANCE OF THE COMPLAINT

I agree that the Commission has "reason to believe" that a violation of Section 5 has been committed by International Harvester in this case, but I cannot agree that it is in the public interest for a complaint to issue. International Harvester has already completed the better part of an extensive program to remedy the alleged violation of law and it is unalterably committed by events to take those steps that remain. This remedial program was planned before the Commission began its investigation of International Harvester, and within days of being formally contacted by Commission staff and apprised of their suggestions, International Harvester modified its program to take those suggestions into account.[1]

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[*] Paul Rand Dixon, Commissioner 1961-1981.

[1] In stating my reasons for dissenting from the issuance of the complaint, I am mindful that any or all of the matters I discuss may be subject to proof or dispute at the trial, and I shall base any decision I am required to make upon the record developed there. My dissent is based only upon matters that I now have "reason to believe" as a result of the Commission's brief investigation of this case. The evidence before the Commission as to the scope of IH's pre-investigational remedial initiatives is certainly subject to a variety of possible interpretations.

I should also note that I draw no inference whatsoever about IH's liablity under Section 5 from the fact that it has chosen to warn farmers about the possible risks of fuel geysering. IH contends that the number of reported geysering incidents (estimated variously as between about 30 and 60) works out to one incident per 500 million tractor operating hours. IH further contends that geysering can occur only when a tractor is running hot and the gas cap is loosened. IH also notes that the incidence of geysering is related to the age of the tractor and the recent

(footnote cont'd)

International Harvester has, however, refused to agree to a consent order requiring it to do what it has already done or will soon do. [2] Under the unusual circumstances described, I would not commit the Commission to the considerable time and expense that litigation entails. I would simply announce the existence of this investigation, announce the program that Harvester long ago began (and modified at our request), and hold that investigatory file open against the exceedingly remote possibility that Harvester fails to complete a program that it has publicly pledged itself to complete to hundreds of thousands of consumers and nearly two thousand dealers.

The Commission's investigation of International Harvester was commenced in late May, 1980. The first formal notification to International Harvester that the investigation had begun occurred in July, 1980. On July 29, 1980, the Commission authorized its staff to seek a preliminary injunction to remedy the alleged violation of law. Before proceeding to court the Commission's staff made substantive contact for the first time with representatives of IH, and learned that the company had begun more than one year earlier to plan a program that would warn of and remedy the danger of fuel geysering.

The program began in Spring, 1979 by International Harvester, and in which it had already expended some millions of dollars, contemplated development of a new gas cap for the pre-1975 model tractors subject to the alleged hazard, provision of the gas cap to dealers, notification of owners of affected tractors as to alleged safety hazards in their operation and the availability of a fix, and follow-up notification in various farm journals.[2]

Harvester has completed work on the gas cap and is about to distribute it. After being contacted by FTC staff in August, 1980, Harvester adopted various of their suggestions as to the text of a warning letter to be sent to consumers, and mailed more than 600,000 such letters in mid-August. The letters to consumers promise them a free gas cap in exchange for the one presently on their tractors. The letters to Harvester dealers commit Harvester to a follow-up program of media publicity for its replacement program. Given the advanced state of its

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increase in the volatility of tractor fuels. All of these asserted considerations may bear upon whether fuel geysering in IH tractors is actually a "safety hazard" and upon whether IH was under any legal obligation to take the steps that it has. While I do join in the Commission's "reason to believe" determination, I also believe that the case is somewhat closer than the necessarily bare-bones assertions in the complaint may suggest.

[2] While my review of the evidence indicates to me that all of the aforementioned elements were contemplated in the program that Harvester officials began planning in Spring, 1979, I can find no evidence to indicate that they planned to relate the generalized safety message of "gasoline fire hazards" to specific incidents of fuel geysering in early model Harvester tractors. Drawing such a connection, of course, might well increase significantly the seriousness with which any warning would be regarded. Such a connection is drawn in the letters actually mailed by Harvester in August, 1980. To the extent that this may be a product of suggestions by FTC staff members, I think that they are to be commended for this, and for any other changes Harvester may have made in its program in response to staff suggestions. But given that Harvester was in a position to complete the details of an acceptable remedial program within so short a time of FTC intervention I cannot agree that the Commission's involvement necessitates an order.

program, the [3] large investment already made in it, and the commitments publicly undertaken by Harvester in letters to hundreds of thousands of consumers and nearly two thousand dealers, I find no credible basis for doubting that Harvester will complete those steps of its remedial program that have yet to take place.

In the ordinary Commission case, the bulk of what constitutes adequate relief consists of requirements that a company "go and sin no more." In those cases, it is quite reasonable for the Commission to insist that the company's future compliance be guaranteed by an order to cease and desist, carrying with it substantial civil penalties if violated. Relief in such cases consists not of expenditures made in the present but of abstinence from certain acts stretching far into the future. There can clearly be no guarantee that relief of this sort will be achieved without the financial deterrent of an order.

This case is different. Regardless of what one may think of IH's motivations in undertaking its gas cap program, it seems to me that it has been undertaken (long before the Commission intervened) and is now in its final stages. There is no conclusion to question whether an order is needed to secure effective relief; that relief is largely secured. In what way, then, will the substantial expenditure of funds that any litigation entails benefit consumers in this case?[3]

It might be argued that it sets a poor precedent and undermines law enforcement efforts in other cases for the Commission not to place under order a respondent that has allegedly violated the law in a serious way. So far as I can see, however, the only precedent established by not litigating this case would be that anytime the Commission begins an investigation and finds that the investigated party has long had underway a remedial program which it conforms to FTC standards immediately upon being first contacted by FTC staff, the Commission will not insist that the provision of such relief to consumers be celebrated by the issuance of an order to cease and desist. Far from being an occurrence to dread, such immediate voluntary compliance strikes me as an occurrence to welcome. I would gladly see the Commission issue fewer orders if that meant more immediate but still effective relief for the victims of alleged safety hazards.[4] [4]

Where effective relief is achieved by a company without substantial Commission involvement, the Commission must seriously consider conserving its scarce resources for cases where they will do more good. In my opinion, the lawsuit being undertaken today will do little or nothing to augment the protections already being afforded owners of IH tractors, nor will it serve to vindicate any broader principle of sound law enforcement that I can discern. Therefore, I would make public what has transpired but not issue the complaint.

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[3] The Notice of Contemplated Relief attached to the Commission's complaint does indicate that the Commission may order that IH desist from failing to notify of any future hazards in its tractors, if it is found in violation of Section 5. The Commission has not, however, routinely insisted upon such prospective orders in cases of this kind for various reasons, and in this case such relief seems unnecessary.

[4] It may be argued that the violation alleged here has continued for many years, and was remedied by IH for other than eleemosynary reasons. Assuming *arguendo* that this is true, it seems to be irrelevant. The only proper purpose of a Commission order is to relieve. The past conduct of an alleged violator may be probative of whether it can be expected to undertake voluntary remedial steps in the future absent an order. But where expensive relief has *already* been undertaken, I cannot see how it makes any difference to any proper concern of the Commission's whether the violation has been long-lived or not.

October 10, 1980

INITIAL DECISION BY

JOHN J. MATHIAS, ADMINISTRATIVE LAW JUDGE

JULY 16, 1982

PRELIMINARY STATEMENT

The Complaint in this matter was filed on October 10, 1980, and charged International Harvester Company (IH), a corporation engaged in the design, manufacture and marketing of agricultural equipment, including tractors, with failure to disclose material facts to operators of tractors which it manufactured, in violation of Section 5 of the Federal Trade Commission Act, as amended (Complaint, ¶ 10).

The gravaman of the charges against respondent is that gasoline-powered tractors which it manufactured since 1939, having the fuel tank located in front of the operator and between the operator and the engine, are subject to a safety hazard which has been termed "fuel geysering." It is alleged that in all of such tractors "the location, and in some cases the shape of the fuel tank, . . . subjects the tank to fuel [2] heating and vaporization causing pressure build-up in the fuel tank during normal operations." It is further alleged that "[i]f the fuel cap is dislodged or removed while the tractor is hot or running, fuel vapors and liquid fuel can shoot or geyser" out of the fuel tank "spraying the operator or the tractor with gasoline which can, and has, spontaneously ignited." Such phenomenon, it is alleged, can and has resulted in serious injury, and even death, is not reasonably to be expected by "many operators," and is, therefore, a "safety hazard" (Complaint, ¶ 5).

It is further alleged that respondent was aware of this problem in 1958, or earlier, and failed to adequately disclose the facts concerning "the nature or extent of injuries due to fuel geysering and steps which might be taken to prevent injury or death." It is charged that if the facts concerning pressure build-up and fuel geysering had been known by many operators it "would likely affect their decisions concerning the use or care of agricultural equipment manufactured by respondent. . . ." As to prospective purchasers of new or used tractors manufactured by respondent, it is urged that if they knew such facts it might affect their decision to purchase that equipment. It is therefore alleged that respondent's failures to disclose this information constitute deceptive or unfair acts or practices or unfair methods of competition in or affecting commerce (Complaint, ¶ 8).

The Complaint does not allege that respondent's gasoline-powered tractors were defective, nor does the Complaint charge that respondent's tractors represented anything other than the state of the art in the design and manufacture of tractors for farm use during the periods when they were manufactured.

Respondent generally denies the allegations of the Complaint, but it admits that incidents alleged to have involved fuel geysering have occurred on IH tractors and that injuries and one death have occurred in such incidents. It specifically denies, among other things, that fuel geysering can occur during the normal operation of its tractors, that such incidents are numerous, and "that fuel geysering can or will occur on any IH gasoline-powered tractor if the operator securely tightens the cap, the gas cap is in reasonable working order and the operator abides by the basic safety instruction not to remove the gas cap when the engine is running or hot." It admits that if fuel geysering does occur, it is a safety hazard (Answer, ¶ 4). It also raises a number of affirmative defenses in its answer, which range from contesting the Commission's jurisdiction to allegations that the proceeding is moot. **[3]**

The principal issues presented for hearing were:

1. Does fuel geysering occur on IH gasoline-powered tractors due to pressure build-up which occurs during the normal operation of such tractors?

2. Are there basic safety rules which, if followed, would prevent fuel geysering?

3. Were those basic safety rules so obvious and well-known that all operators of gasoline-powered tractors should have been aware of them and followed them?

4. Under the circumstances revealed by the evidence, was respondent's knowledge of alleged fuel geysering incidents and the phenomena which could give rise thereto, such that it imposed a duty on IH to disclose this safety hazard to users and prospective users of its gasoline-powered tractors?

5. If there was a duty to disclose, did IH's actions at any particular point in time discharge that duty under the conditions existing at that time?

6. Have the users of IH's gasoline-powered tractors now been adequately warned of the safety hazard of fuel geysering?

7. Has there been a violation of Section 5 of the Federal Trade Commission Act and, if so, what, if any, kind of order is required?

The hearing in this matter commenced on Tuesday, October 13, 1981, and the record was closed on Friday, February 26, 1982. During the course of their case-in-chief and rebuttal complaint counsel called 26 witnesses and introduced well over 300 exhibits into evidence. Respondent in its defense called 24 witnesses and introduced into evidence about 200 exhibits. The hearings consumed a total of 34 trial days and 5662 pages of transcript.

This initial decision is based upon the entire record including proposed findings of fact and conclusions of law and supporting memoranda filed by the parties, as well as their replies. I have also taken into account my observation of the witnesses who appeared before me and their demeanor. Proposed findings not herein adopted, either in the form submitted or in substance, are rejected either as not supported by the evidence or as involving immaterial matters. [4]

The findings of fact include references to supporting evidentiary items in the record. Such references are intended to serve as guides to the testimony and exhibits supporting the findings of fact. They do not necessarily represent complete summaries of the evidence supporting each finding. The following abbreviations have been used:

Tr. – Transcript, preceded by the name of the witness and followed by the page number.
CX – Complaint Counsel's Exhibit, followed by its number and the referenced page(s).
RX – Respondent's Exhibit followed by its number and the referenced page(s).
CF – Complaint Counsel's Proposed Findings.
CB – Complaint Counsel's Memorandum Of Law In Support Of Proposed Findings.
RF – Respondent's Proposed Findings.
RB – Respondent's Memorandum Of Law In Support Of Proposed Findings.
CRF – Complaint Counsel's Reply To Respondent's Proposed Findings.
CRB – Complaint Counsel's Reply Brief.
RRF – Respondent's Reply To Complaint Counsel's Proposed Findings.
RRB – Respondent's Reply Brief.

FINDINGS OF FACT

I. THE RESPONDENT

1. International Harvester Company is a Delaware Corporation with its executive offices located at 401 North Michigan Avenue, Chicago, Illinois. Respondent is engaged in the design, manufacture, and marketing of three major product [5] lines: agricultural equipment, construction machinery and highway trucks. IH and its corporate predecessors have been major suppliers of farm machinery since the 1840's. Its agricultural equipment line includes, among other things, tractors (Complaint and Answer, ¶¶ 1, 2; Colwell, Tr. 3635; McCormick, Tr. 1492-93; RX 49, p. 153).

2. IH built its first farm tractor in 1906. Since then it has been a pioneer in the development of the agricultural tractor. In 1939, it introduced a new gasoline-powered tractor, the Farmall "M", which was geared to modern power farming and gave the farmer the capacity to perform a wide variety of farming tasks by mounting different power-driven implements on his tractor. The Farmall line also included the model "A" and "H" tractors. These basic models, with some improvements over the years, were IH's primary farm tractors through 1954. Beginning in 1955, IH also marketed a line of utility tractors. The utility tractors had a lower profile and were closer to the ground. They were suitable for many farming chores. Since the mid-1950's respondent has built many different models of tractors, generally of increasing size and horsepower (RX 49, pp. 154-62; RX 89H-I; Coleman, Tr. 963, 967, 1051, 1318-20, 1329-36; Link, Tr. 1995; Borghoff, Tr. 4000-02).

II. COMMERCE

3. IH distributes and at all relevant times distributed, agricultural equipment including tractors and accessories and parts therefor through its independent dealer organization. In the late 1940's there were 7000 dealers in North America (including Canada), but the overall number of dealerships has since declined and the dealerships have become larger. As of today there are about 2000 of such dealers in the United States and Canada. Respondent also sells its agricultural equipment through a few company-owned retail stores. As of October 1980 there were 10 of such company-owned stores. These were located in the states of New York, Alabama, Mississippi, Kansas, Oklahoma and Texas (RX 220; Gast, Tr. 3749-50; Hartzell, Tr. 2950-51; Hill, Tr. 3834; Allen, Tr. 3684; *Affidavit of James R. Fruchterman, attached to Motion to Dismiss for Absence of Conduct in Commerce*, February 6, 1981).

4. IH causes the agricultural equipment, including tractors, accessories and parts to be shipped from the place of manufacture to independent dealerships and its own retail stores in the various states, including states other than the place of manufacture. Such tractors, accessories and parts are then sold by the dealerships and the company-owned stores to customers in their respective sales areas. The number of gasoline-powered [6] tractors manufactured and sold by IH declined precipitously in the 1970's. Respondent has not manufactured and shipped any gasoline-powered tractors since 1978. It does continue to print owner's manuals and supply accessories and parts for the tractors which have gone out of production and distribute these through the normal distribution channels in interstate commerce. It also prints, and distributes interstate, parts catalogues for such tractors, which parts catalogues are sent through its mailing list to farmers in the various states urging them to purchase parts and equipment through the dealerships and stores (Complaint and Answer, ¶¶ 3, 4; CX 219A-B, CX 221; CX 269; CX 269–Z–96; CX 270K; CX 272K; CX 351; RX 5 (p. 7); RX 26 (p. 16); RX 26 (p. 29); RX 89H-I; RX 211; RX 220; Bennett, Tr. 3161, 3240–41; Lirtzman, Tr. 4707–09).

5. It is alleged in the Complaint that a substantial number of respondent's gasoline-powered tractors "may still be in use and be subject to resale by respondent [through its company-owned retail stores] or its dealers." The only evidence in the record concerning the sale of used gasoline-powered tractors in IH's company-owned stores is an affidavit of James R. Fruchterman, reporting on a survey of the 10 company-owned retail stores made in the Fall of 1980, which showed that as of October 21, 1980, there were, collectively, five used gasoline-powered tractors in inventory in said stores. No other evidence was introduced by complaint counsel to show any other course of dealings in such tractors by the company-owned stores. Therefore, respondent's dealings in used tractors must be considered *de minimis*(*Affidavit of James R. Fruchterman, attached to Motion to Dismiss for Absence of Conduct in Commerce*, February 6, 1981).

6. However, based on the evidence cited in Findings 3 and 4 above, I find that respondent has, at all times relevant to the Complaint, been engaged in a substantial course of trade or commerce, as defined in the Federal Trade Commission Act, with respect to the tractors which are the subject of the Complaint (*See also*, RX 89H-I).

7. In the course and conduct of such business in commerce, at all times relevant to the charges of the Complaint, respondent IH has been and is now in substantial competition in commerce with corporations, firms and individuals engaged in the manufacture, sale and distribution of agricultural equipment, including tractors (RX 49A; Coleman, Tr. 1321—23).

III. RESPONDENT'S GASOLINE-POWERED TRACTORS

8. The evidence in this case was limited to respondent's gasoline-powered tractors over 25 horsepower used in farm [7] operations, the fuel tanks of which were located between the engine and the operator. This excludes all tractors designed for home use and industrial tractors, as well as a number of gasoline-powered tractors which IH manufactured in the later part of the complaint period, which had the fuel tank located behind the operator (*Order Respecting Complaint Counsel's Subpoena Duces Tecum*, January 21, 1981; RX 89H-I; CX 221). The model designation of the tractors in issue, as well as the years during which they were built are as follows:

Model	Years Built
A, AI, AV, B, SA, SAI, SAV	1939–1955
100 and 130	1955–1957
140	1958–1978
C and SC	1948–1954
H, M, SMTA, W–4, W–6, SH, SM, SW–4, SW–6	1939–1954
200	1954–1955
F–230	1957
F–300	1955–1956
I–300	1955–1956
F–400	1955–1956
I–400	1955–1956
I–350	1957–1958
F–350	1957–1958
I–330	1956
F and I–240	1958–1961
F and I–404, 2404	1962–1967
424, 2424	1956–1967
444, 2444	1968–1971
F–450	1956–1958 [8]
I–450	1956–1958
I–340	1958–1963
F–340	1958–1963
I–504, 2504 2500 Constructall	1963–1967
I–600	1956
I–650	1957
F–504	1960–1967
I–460	1958–1963
F–460	1958–1963

Model	Years Built
F and I–560	1958–1963
I–660	1958–1963
I–606	1964–1967
F–544	1968–1973
I–544, 2544	1968–1973
I–656, 2656	1968–1973
F–656	1965–1971
F and I–706, I–2706	1963–1967
F and I–806, I–2806	1963–1967
F and I–856, I–2856	1967–1970
F–666, Hydro 70	1972–1975
686, Hydro 86	1976–1978
F–766	1971–1976
F and I–826, I–2826	1969–1971
F and I–756, I–2756	1967–1970

(RX 89H–I). **[9]**

The models preceded by the letter "F" are of the Farmall line, while those preceded by the letter "I" are of the utility line of tractors (Coleman, Tr. 1051, 1329-31). During the period 1939 to 1978, IH built a total of 1,363,063 of the tractors listed above (RX 89H-I).

9. Although all of the tractors listed in Finding 8, above, had the fuel tank located between the operator and the engine (CX 219A-U; CX 221A-C; Coleman, Tr. 971–72), where were substantial differences in design and horsepower among such tractors (CX 219A-U; Link, Tr. 1995). However, within the above list, various of the tractors can be grouped together with respect to their design, insofar as the type of fuel tank and its location in relation to the engine and operator's seat are concerned. The first seven tractors and groups of tractors listed above, down through F-230, had the same teardrop fuel tank, not covered by the hood, located in the same location between the engine and the operator's seat, (CX 219A; CX 221A; Coleman, Tr. 971), except that the 4 and 6 models in the fifth group have a different seat location (CX 219A). The 240 model is essentially the same as the 340. Models B–275, B–414, 404, 444 and I–504 are essentially the same as Model 424. The I–300 and 330 are essentially the same as the I–350 and the F–300 is essentially the same as the F–350. F and I–400's are essentially the same as the F–450. The F–460 is essentially the same as the F–560, and the I–460 as the I–560. Models I–544 and I–606 are essentially the same as the I–656. The F–666, 686, the Hydro 70 and the Hydro 86 are essentially the same as the F–656. The F–504 is essentially the same as the F–544. Models 766 and 826 are essentially the same as Model 756. The I–806, I–856 and I–756 are essentially the

same as the I–706. The 600 and 650 are essentially the same as the "M", and the 660 is the same as the 560, except for the seat location (CX 219A-U).

IV. FUEL HEATING, VAPORIZATION AND PRESSURE BUILD-UP

10. In all of the tractors listed in Finding No. 8, above, the location of the fuel tank subjects it and the gasoline within it to additional heat from the engine during the normal operation of the tractor. This is due both to the radiator fan blast and radiation from the engine.[1] (Creighton, Tr. 2245; [10] CX 43C-D; CX 47; CX 51; CX 55 through 58). Most of the models of IH gasoline-powered tractors where the fuel tank is enclosed by a cowling also include a heat shield which lowers the fuel tank temperatures somewhat. The heat shield is designed to deflect the radiator fan blast away from the tank. However, this shield primarily delays the heating process. The fuel tanks which are so equipped still suffer from temperature rise well above the ambient temperature, when the tractor is operated for a substantial period of time (Link, Tr. 2025-26; Den Besten, Tr. 1794; CX 19B, CX 46A; CX 48D; CX 51A-B; CX 55D; CX 56D-E; CX 58B; CX 81A-B; CX 382A-C).

11. The heat from the engine reaching the fuel tank can increase the temperature of the fuel as much as 65° F. above that of the ambient air (CX 16D-E; CX 17A-B; CX 19A-B; CX 43Q; Coleman, Tr. 1069, 1072, 1076; Den Besten, Tr. 1805; RRF 90). Engine heat can increase fuel temperature by 69° F. in three hours, even when the tank is equipped with a heat deflector (CX 382A-C; RRF 90). Even after the engine is stopped, fuel tank temperatures may continue to rise for a time, because of the residual heat stored in the engine (CX 79B; CX 379, Ziskal Dep., pp. 104–105; Coleman, Tr. 1209–10; RRF 90).

12. As the temperature of the gasoline in the fuel tank rises, it begins to vaporize. Gasoline is a blend of various hydrocarbons beginning with those with four carbon atoms, up through hydrocarbons with 9 or 10 carbon atoms. Those hydrocarbons with the lowest number of carbon atoms, the butanes and pentanes, are known as the "light ends." These "light ends" have a dominant influence on fuel volatility. The "light ends" begin to vaporize at about 95-97° F. (Creighton, Tr. 2271–72; Hurn, Tr. 3899–3900; CX 379, Ziskal Dep., pp. 27–34).

13. When the gasoline in the tank vaporizes more rapidly than it can be vented by the cap, pressure builds up in the fuel tank (CX 16D-E; CX 17; CX 19A-B; CX 43Q; CX 44A; CX 55B; CX 58; CX 64A; Creighton, Tr. 2207; RRF 93).

14. Other things also have an effect on the degree to which pressure

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[1] The radiator fan blast is a stream of hot air blown away from the engine by the radiator fan (Creighton, Tr. 2246).

is built up in the fuel tank. Agitation of the fuel, which occurs during normal operations as the tractor is driven over rough ground, can temporarily increase pressure in the fuel tank as much as 50% to 100% (CX 46C; RX 32, p. B–80; Creighton, Tr. 2251–53; Coleman, Tr. 1174–75). The shape and size of the fuel tank can also affect fuel heating and fuel pressure (RRF 97). Heat and consequent pressure build-up are also affected by external conditions. The velocity and direction of the wind and radiant heat from the sun can have an important effect on the temperature of the fuel and the resultant pressure build-up in the fuel tank (Creighton, Tr. 2253–54; Coleman, Tr. 1010; RRF 98). Although pressure build-up can occur at widely disparate temperature ranges of the outside air, the [11] ambient air temperature can also play an important part in raising the temperature of the fuel in the tank, and, consequently, the pressure within the tank (CX 208J; Hartzell, Tr. 2963–64). Some equipment or accessories mounted on the tractor, such as corn pickers, heat housers and front end loaders, tend to trap heat near the engine and fuel tank and can also be factors in raising the temperature of the fuel and causing pressure build-up (CX 379, Ziskal Dep., pp. 29–30, 41).

15. Fuel volatility is also a very important factor in pressure build-up in the fuel tanks of these tractors. A more volatile fuel is more hazardous because it has an increased tendency to form vapors and the more vapor that is discharged into a contained vessel at any given temperature, the greater the potential for pressure build-up within the container. There is also more opportunity for fire with a fuel of higher volatility (Hurn, Tr. 3935–36). Gasoline volatility has been generally increasing since the 1930's (Hurn, Tr. 3924, 3957, 3967). For example, the volatility of gasoline produced in the Spring in the Midwest has increased by 20% during the period 1965 to 1980 (CX 153).

16. The volatility of fuel is also greatly affected by the practice of refiners to produce different blends of gasoline for the different seasons of the year. Winter fuel is more volatile in order to improve starting capability (Hurn, Tr. 3899–3902). However, pressure build-up in the fuel tanks of the tractors at issue can occur even when summer-grade gasoline is used (Hartzell, Tr. 2979).

17. Other factors can also affect the amount of pressure build-up in the fuel tank of these tractors. The venting capacity of the fuel cap can affect the pressure in the tank. If the vent hole is plugged with dirt, or missing, then vapor cannot escape from the tank at all and pressure build-up is greatly increased (CX 38; CX 49B; CX 68; CX 69B; Reed, Tr. 3027–28). Tractor maintenance can also play an important part in increasing the temperature to which the fuel tank is subjected and, thus, the pressure build-up within it. A poorly maintained trac-

tor may expose the fuel tank to a greater amount of heat (RX 220B; Bennett, Tr. 3187; Allen, Tr. 3690-91).

18. Some of the symptoms which accompany the pressure build-up in the fuel tanks of the IH tractors are: boiling of the gasoline in the fuel tanks (Coleman, Tr. 1069, 1072; Nichols, Tr. 2092; CX 24A; CX 27B; CX 44A; CX 45A; CX 90; CX 112; CX 163A; CX 171B); a hissing sound created by the gasoline vapors escaping through the vent in the filler cap (CX 35A; Creighton, Tr. 2276; Didion, Tr. 673; Clowes, Tr. 1834-36; Cox, Tr. 830; Holtz, Tr. 718-19); "vapor lock" caused by fuel vaporizing in the fuel line or carburetor, which can cause the [12] engine to sputter or "die" (CX 35; CX 80; RX 25Y; Creighton, Tr. 2777); surging of the engine, because the pressure forces too much fuel into the carburetor (Coleman, Tr. 1015–16; Creighton, Tr. 2295); stalling of the engine due to flooding, when the pressure forces too much fuel into the carburetor (Coleman, Tr. 1003); and gas squirting out of the vent hole of the fuel cap (CX 46A; CX 119A; CX 177; Coleman, Tr. 999–1000, 1004–05, 1012; Cameron, Tr. 401).

V. FUEL GEYSERING

19. When sufficient pressure has been built up in the fuel tank and it is suddenly released, such as when the gas cap is suddenly removed from a hot or running tractor, there may be a sudden ejection or expulsion of gasoline and gasoline vapors out of the filler neck. Such ejection or expulsion has sometimes been called "fuel geysering." As used in this case, the term "fuel geysering" has included varying degrees of fuel loss, ranging from a spray to a solid column of gasoline (Creighton, Tr. 2190; Coleman, Tr. 1077, 1140, 1337; CX 44; CX 250 through 254; CX 375A-B; RRF 86). Fuel geysering involves the release of energy accumulated in the liquid mass of the fuel as boiling is suppressed by built-up vapor pressure (Coleman, Tr. 1142).

20. Fuel geysering can occur when pressure exceeds 1 pound per square inch (psi) in the fuel tank (CX 46B). Tank pressures as high as 5 psi can be attained during the normal operation of one of the subject tractors (Hillstrom, Tr. 3553; Den Besten, Tr. 1805; CX 44A-B; CX 45A-P; CX 55A-B; CX 56A; CX 57A; CX 58A-B; Findings No. 66, 69, 71, 76–80, 82–83, 85, 88, 96, 99–101, below).

21. Geysering is affected by the level of fuel in the tank. Generally, fuel tank pressure follows a curve in which it increases gradually to a peak, then decreases as more of the fuel is used up (CX 57F-H; RX 267M-N; CX 379, Ziskal Dep., p. 27; Coleman, Tr. 1681; RRF 103).

22. Fuel geysering is the result of a combination of circumstances involving pressure build-up, fuel temperature, the amount of fuel in the tank and the sudden release of the pressure in the tank (Reed, Tr. 3024–30; RRF 103; Findings No. 19–21 above). Respondent admits

that under some combination of circumstances fuel geysering could occur on all of the IH gasoline-powered tractors listed in Finding No. 8, *supra* (CX 216D; RRF 86, 103).

23. A "fuel geyser" can result in the expulsion of a stream of vapor and liquid fuel to a height well above the tractor and its operator (Buatte, Tr. 149; Cameron, Tr. 401; Didion, Tr. 675). Fuel gushed 20 feet high and fuel loss was seven [13] gallons, when IH tested one of its production tractors at a fuel tank pressure of 2 psi with the tank 3/4 full (CX 46B). One farmer who experienced fuel geysering said, "It was frothy-looking—it appeared to be like a frothy-looking orangeish white mass, and it just went up like that" (Cameron, Tr. 402). Another described the release of pressure when he removed the cap by stating, "You couldn't put any more pressure in there with an air hose. . . ." (Shawback, Tr. 583). Other farmers tried to put the cap back on the filler neck, but were unable to because of the pressure (Greathouse, Tr. 201).

24. The fuel expelled from the tank may fall on the operator soaking him with gasoline (CX 28; Buatte, Tr. 148–49; Cameron, Tr. 400–02; Shawback, Tr. 582). Even if the fuel does not spray directly on the operator, he can be burned if it ignites (Kangas, Tr. 489–93; Greathouse, Tr. 201–02).

25. The fuel which is ejected from the tank of a hot or running tractor can ignite in several ways. Fuel ignition can occur if the tractor is hot (CX 29D). The auto ignition temperature of gasoline (that is, the temperature at which gasoline will ignite without a spark or an open flame, also known as spontaneous ignition) is 800°–860° F. The exhaust manifold of the tractor can reach temperatures as high as 1,200° F. Other sources of ignition include: sparks from the commutator brushes on the generator, or from the muffler (CX 28D; CX 36H; CX 379, Ziskal Dep., pp. 46, 49; Coleman, Tr. 1211; RX 27–4; Creighton, Tr. 2280–85, 2292–94), and bits of dirt and chaff which can get on hot parts of the tractor during operation and serve as sources of ignition (Sullivan, Tr. 5138; CX 379, Ziskal Dep., p. 42). Ignition will not occur every time liquid gasoline comes in contact with a hot or running tractor, but it is always a possibility (Creighton, Tr. 2292–94).

26. Ignition can occur almost simultaneously with the release of fuel. One witness testified that:

> . . . [w]hen I opened the gas cap up, gas shot in the air. It said "Whoosh" and gas went about two and a half, three feet. Then I tried forcing the cover back on, but it was all engulfed in flames right away, as soon as the gas came out. (Wholetz, Tr. 634.)

Wayne Shawback said:

> Well, the minute I got sprayed with gas, I reached for the switch to shut the motor off. But that time, it had ignited. I was one ball of fire. (Shawback, Tr. 583). [14]

27. Fuel geysering can result in serious injury, and even death. It is undisputed that Charles Kraus died as a result of a fuel geysering incident in 1978 (CX 308; Creighton, Tr. 2237–39; Bennett, Tr. 3356–57). Eleven other incidents about which there was testimony at trial resulted in serious injury (Buatte, Tr. 149; Greathouse, Tr. 208–10; Cameron, Tr. 405–09; Kangas, Tr. 489–93; Shawback, Tr. 584–85; Wohletz, Tr. 635; Didion, Tr. 675; Holtz, Tr. 720; D. Jolicoeur, Tr. 765; S. Jolicoeur, Tr. 818–19; Cox, Tr. 832; Clowes, Tr. 1838). In one incident related at trial, the operator escaped relatively uninjured, but the fuel exploded and the tractor was heavily damaged (Guynn, Tr. 890, 903–04, 908–09; CX 265; CX 266; CX 267). IH acknowledges that one, perhaps two, additional deaths have occurred in "alleged" fuel geysering incidents (*Answer*, ¶ 5; CX 220A-K; *Supplemental Memorandum in Opposition to Complaint Counsel's Motions for Leave to Submit Additional Evidence on the Issue of Public Interest,* July 21, 1981, pp. 9–11).

28. Although a number of fuel geysering incidents did not involve personal injury, those which did often resulted in extremely serious burns, disfigurement and permanent impairment (Buatte, Tr. 175; Greathouse, Tr. 208–10; Cameron, Tr. 405–09; Wohletz, Tr. 635; Didion, Tr. 675; Holtz, Tr. 720–21; S. Jolicoeur, Tr. 818–19; Cox, Tr. 832–33; Clowes, Tr. 1837–38).[2]

29. The record contains evidence of more than 90 alleged fuel geysering incidents involving respondent's tractors which occurred from the mid-1950's through August 1981 (CX 24A; CX 48D; CX 53; CX 220; CX 409; CX 410; Sullivan, Tr. 5159; Rezek, Tr. 3102; Nichols, Tr. 2092–93; Clowes, Tr. 1840). Moreover, one early report (1955) simply states that complaints had been received by IH "stating the owners were sprayed with gasoline when removing the fuel cap due to pressure build-up in the fuel tank" (CX 19A). Obviously this indicates more than one occurrence, but whether it represents many, or few, cannot be determined. Then too, some of respondent's files on early incidents were lost or discarded, so it is possible that some [15] fuel geysering incidents which were reported to IH are not identified on this record (Bennett, Tr. 3289–90, 3323–25; CX 44A; CX 48D). Some fuel geysering accidents were not reported to respondent (Bennett, Tr. 3361–64; CX 440; RX 254A-H), and others are reported years after the occurrence (CX 379, Ziskal Dep., p. 84; CX 440). Therefore, the num-

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[2] I curtailed complaint counsel's examination of injured witnesses in an off-the-record discussion with counsel very early in the hearings, since it obviously caused some of the witnesses mental anguish to testify as to the extent of their injuries and since such testimony was unnecessary. It was obvious from seeing some of the witnesses that they had been severely injured and disfigured.

ber of fuel geysering incidents established on the record herein cannot be considered a complete enumeration of all such accidents.

30. Respondent points out in its Reply to Complaint Counsel's Proposed Findings that CX 220, an affidavit of an IH official and a supplement thereto, which is the principal listing of alleged fuel geysering incidents in this record, contains as many as four accidents which did not involve "fuel geysering," but rather involved fuel "spurts" (gas squirting through the vent hole) (RRF 119). Such fact does not materially affect the number of fuel geysering incidents as listed in Finding No. 29, above. Further, respondent urges that a number of the other accidents reported as "fuel geysering" may not have involved that phenomenon. However, I find that the weight of the evidence establishes that all of the incidents to which there was direct testimony offered herein by operators involved in such accidents, with the exception of the Killingbeck incident, were "fuel geysering" incidents (Buatte, Tr. 146–82; Greathouse, Tr. 183–235; Cameron, Tr. 352–448; Kangas, Tr. 477–568; Shawback, Tr. 569–611; Wohletz, Tr. 624–59; Didion, Tr. 662–707; Holtz, Tr.709–43; D. Jolicoeur, Tr. 752–811; S. Jolicoeur, Tr. 812–21; Cox, Tr. 823–39; Guynn, Tr. 870–941; Clowes, Tr. 1825–70; Nichols, Tr. 2085–2117). In addition, the weight of the documentary evidence of record indicates that fuel geysering was definitely involved in the Bedke, Binder, VandenHoek, and Ostendorf accidents (CX 28A-G; CX 40; CX 144A; RX 262). Based on these established cases of fuel geysering and respondent's admissions that the other incidents counted in Finding No. 29, *supra*, were alleged fuel geysering incidents (with the exception of as many as four, as mentioned above), I can only draw the inference that all of the accidents referred to in Finding No. 29 actually involved "fuel geysering" (RRF 119, 120).

31. Of the fuel geysering incidents established in the record: more than seven were reported to IH which occurred during the latter half of the 1950's (over four of these were prior to May 1958) (CX 19A; CX 220); at least 25 were reported to respondent as occurring in the 1960's (CX 24A; CX 48D; CX 220);[3] at least 30 were reported which occurred in the [16] 1970's (CX 220); at least 24 were reported which occurred in 1980 and 1981 (CX 220); and at least seven were reported whose date of occurrence is unknown (CX 220)).[4]

32. Under the definition of "fuel geysering" adopted herein, gasoline and gasoline vapors are expelled or ejected out of the fuel tank

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[3] CX 48D mentions that 11 of such incidents were reported in connection with IH's 460 and 560 tractors (manufactured from 1958 to 1963) by the date of the meeting reported therein—March 4, 1961. No date or other information is given regarding these incidents. Since they certainly occurred in the late 1950's or early 1960's, all are credited to the 1960's.

[4] These include as many as four "spurting" incidents (RRF 119). However, since the figures for the 1950's do not take into account all of the incidents referred to in CX 19A and CX 44A, which allude to "field complaints" and "field reports," the total number of incidents established on the record is undoubtedly still over 90.

filler neck when the fuel cap is removed or dislodged (Complaint ¶ 5; Finding No. 19, *supra*). The weight of the evidence in this record establishes that a *properly secured* fuel cap cannot be dislodged or "blown off" (CX 27A-E; CX 46A-R; CX 67A-B; CX 68A; CX 69A-C; CX 108A-F; CX 109A-F; *Concessions of complaint counsel,* Tr. 2362, 2408, *Transcript of telephone conference* of May 7, 1982). The weight of the evidence also establishes that the fuel cap can be removed or dislodged if the operator physically removes it (CX 116), or if an improperly secured cap vibrates off during the operation of the tractor (*see* Finding No. 33, below).

33. The only inference I can draw from this record is that an *improperly secured* gas cap can vibrate off a running tractor. (This includes the situation where the cap or filler neck are so poorly maintained that the cap cannot be properly secured). Several witnesses appeared before me and testified that the fuel cap came off while their tractor was running, without their having touched it (Buatte, Tr. 147–49; Cameron, Tr. 401, 404; D. Jolicoeur, Tr. 763–66; Guynn, Tr. 889–99). I find no basis to doubt their credibility.[5] At the same time, I am precluded by this record, including complaint counsel's [17] concessions, from finding that a properly secured gas cap can "blow off" one of respondent's tractors (*See* Finding 32). However, an expert who testified for respondent in connection with private litigation concluded that an improperly secured fuel cap can vibrate off a running tractor (RX 262J; CX 291H-I; *see also,* CX 28A, CX 52A and Answer ¶ 5) and other evidence indicates that a fuel cap or filler neck might be so poorly maintained by a tractor owner that the cap fits loosely on the filler neck (Cameron, Tr. 442; Nelson, Tr. 4389; Sullivan, Tr. 5120, 5126, 5128-30; Answer ¶ 5), thus giving rise to the inference that the fuel cap might vibrate off under such circumstances. This evidence, coupled with the testimony of Messrs. Buatte, Cameron, Jolicoeur and Guynn, as well as evidence from IH's files that others have made similar claims of blow-offs (CX 28A; CX 44A; CX 61A; CX 119A), gives rise to the inference that a fuel cap can vibrate off the tractor under these conditions and that a fuel geyser might result if the other causal factors are present.

34. There is a reasonable likelihood that the fuel cap on one of respondent's gasoline-powered tractors may be removed or dislodged when the tractor is hot or running. The number of fuel geysering

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[5] For example, respondent contends that Mr. Guynn must have removed the fuel cap and placed it on the right fender, since the physical evidence shows it sat there during the fire (RRF 138). However, it is not beyond belief that a fuel cap blown off a tractor and up into the air might come back down and land on the tractor in an upright position. Since respondent can point to no other evidence to support its contention and Mr. Guynn was the only actual witness to the incident, I have no reason to reject his credibility on this point. Certainly, it is also difficult to perceive of a man who was on fire taking the time to set a fuel cap down before abandoning a burning tractor, notwithstanding the fact that he did have enough composure to first turn off the ignition. (Guynn, Tr. 889-99, 926). Respondent's contention, based on speculation, must therefore be rejected.

incidents which have occurred, while not great in relation to the number of tractors which IH has produced, is a strong indication of such likelihood (Findings 29, 30, 32 and 33). This is especially true for those model tractors which do not have fuel gauges. Mr. Coleman, a retired chief product development engineer for respondent, testified that he was sure that even some of the IH personnel at its test facilities had taken the cap off such a tractor (one without a fuel gauge) when it was running, in order to determine how much fuel was left (Coleman, Tr. 1446). Many of the earlier model tractors involved herein did not have fuel gauges (Coleman, Tr. 1446). [18]

35. Owners and operators of IH gasoline-powered tractors have different degrees of knowledge concerning scientific principles which affect the fuel systems of tractors and tractor operation. Some have advanced formal education in engineering-related areas (Greathouse, Tr. 184–85), while others have had no formal instruction concerning such principles (Cox, Tr. 824–25). Regardless of the amount of training they received, many owners and operators of IH gasoline-powered tractors consider themselves knowledgeable about tractor operation and fuel-handling procedures (Buatte, Tr. 152, 155, 157, 160; Greathouse, Tr. 189–90, 195, 202–05; Cameron, Tr. 357–58, 380–81; Shawback, Tr. 569–70; Wohletz, Tr. 627, 651; Didion, Tr. 667, 670–71, 684–85; Holtz, Tr. 711, 725–27; Guynn, Tr. 873–84, 920–22; D. Jolicoeur, Tr. 754–55, 785–86; S. Jolicoeur, Tr. 812–13; Nichols, Tr. 2086–88, 2091; Clowes, Tr. 1826, 1828, 1868–69; Killingbeck, Tr. 5266–67). IH itself recognizes that farmers are generally familiar with the operation of IH gasoline-powered tractors (Borghoff, Tr. 4141). In fact, IH is aware that many farmers do much of their own tractor maintenance work (RF 411; D. Jolicoeur, Tr. 756; Allen, Tr. 3690-91).

36. Despite their familiarity with tractors and tractor maintenance, however, many tractor owners and operators were not aware of the potential for fuel geysering if the fuel cap were removed or dislodged from a hot or running IH tractor (Greathouse, Tr. 206; Kangas, Tr. 557; Shawback, Tr. 604, 606, 609; Wohletz, Tr. 634, 644–45, 652; Didion, Tr. 700, 705–06; Holtz, Tr. 409–10; Drummond Test. in *Stambaugh* case, CX 285E; Gaul Test. in *Stambaugh* case, CX 286F-G; Borghoff, Tr. 4130; Sullivan, Tr. 5143-44).

37. Had the owners and operators of such tractors been aware of the potential for fuel geysering it might have affected their decisions to purchase new or used tractors of this type, or their manner of care and use of such equipment (Buatte, Tr. 156–57; Greathouse, Tr. 233; Kangas, Tr. 504–05; Shawback, Tr. 589; Wohletz, Tr. 644–45, 652–54; Didion, Tr. 680–81; Holtz, Tr. 722–23).

VI. RESPONDENT'S KNOWLEDGE

A. *The Farm Tractor Engineering Department*

38. Since 1946, the Farm Tractor Engineering Department has been responsible for the design, testing and development of IH gasoline-powered farm tractors (Coleman, Tr. 946–47, 949). Since its inception this department has tested both prototype [19] and production tractors, as well as experimental tractors (Coleman, Tr. 950, 958, 1181, 1203). In general, it was responsible for all testing done on farm tractors by IH, except for testing solely related to quality control (Coleman, Tr. 951–53). However, it did not test individual components such as engines, electrical systems, distributors, filters, etc., not installed on complete tractors. It dealt only with the complete vehicle. (Coleman, Tr. 952).

39. The Farm Tractor Engineering Department, headed by the Manager of Engineering, was composed of two basic groups, the Design Group and Test and Development. Each group was supervised by a Divisional Chief Engineer who reported to the Manager of Engineering, directly or through his assistant. (CX 313; Coleman, Tr. 1184, 1978). IH engineer Richard N. Coleman was in charge of the test and development function during most of the time relevant to this proceeding (Coleman, Tr. 944, 948, 950; RF 24).

40. The Test and Development Group worked in close conjunction with the Design Group. The Design Group often gave Test and Development assignments to work on. (Coleman, Tr. 1072–73). The Test and Development Group, in turn, reported any type of investigation that would require design action to the Design Group (Coleman, Tr. 1181). In addition, the Test and Development Group reported results on prototype tractors which were performed after a design had been committed to a prototype (Coleman, Tr. 1181). The Test and Development Group's work on production tractors was also reported to the Design Group, including those engineers in the Design Group who were working on designs far into the future (CX 1; CX 2; CX 7; CX 11; CX 17; CX 19; CX 20; CX 41; CX 42; CX 44; Coleman, Tr. 1026–27, 1033, 1073, 1083–85, 1094, 1159, 1171, 1178–79, 1182).

41. Among other things, the Test and Development Group conducted field investigations into field problems arising with IH tractors (CX 36; Coleman, Tr. 956–57, 1204). Any written reports of such investigations were circulated to various engineers and in most, if not all, cases to the Divisional Chief Engineer of Test and Development (Coleman, Tr. 957, 1204). In addition, the Design Group requested the Test and Development Group to investigate particular problems arising in the field (Coleman, Tr. 1203). The Test and Development Group was given similar assignments, on occasion, by the Manager of Engineering,

who followed such investigations closely (CX 28; Coleman, Tr. 1119, 1122, 1145, 1216). [20]

B. *The 1940's And Early 1950's*

42. In the early 1940's, IH received reports that "fuel spurting" was occurring on its gasoline-powered tractors (RX 3 and 4). "Fuel spurting" described the condition where a solid stream of gasoline was expelled from the vent hole in the gasoline cap (Coleman, Tr. 1337), as opposed to "fuel geysering" wherein fuel and vapors are ejected from the filler neck when the cap is removed or dislodged. At the time fuel spurting came to IH's attention, IH gasoline-powered tractors used a flat gasoline cap which had a 1/16th inch vent hole in the top to allow proper venting of gasoline vapors inside the tank (RX 3; RX 131; Coleman, Tr. 1002, 1006, 1343, 1647, 1695; CX 379, Ziskal Dep., p. 21).

43. "Spurting" occurred when the cap was fully in place on the filler neck and involved a combination of factors, primarily the sloshing of fuel in the tank and the exhaling through the vent hole of pressure built up in the tank (Coleman, Tr. 999, 1000). The sloshing of fuel caused the fuel to get up into the chamber on the underside of the cap, where it was forced out of the vent hole as the pressure in the tank was exhausted during the normal venting process (Coleman, Tr. 1000). The pressure in the tank was caused by increased fuel temperatures due to heat flow to the tank (CX 1; RX 162; RX 163; RX 169; Coleman, Tr. 999-1004). Fuel spurting was a very common occurrence on IH tractors during the 1940's and early 1950's (Coleman, Tr. 1337–38).

44. IH knew, even in the 1940's and early 1950's, that increased fuel volatility could increase the pressure within the gasoline tank of its tractors, leading to a greater incidence of fuel spurting (Coleman, Tr. 1007–08). IH found that fuel spurting was most likely to occur in the Spring and Fall seasons and in hot-weather operations (Coleman, Tr. 1032; CX 379, Ziskal Dep., pp. 22–23).

45. IH received many reports of fuel spurting between 1941 and 1954; with such reports increasing in the late 1940's and early 1950's (RX 3; RX 161; RX 175; CX 1; CX 2; CX 6; CX 64A; Coleman, Tr. 1346). IH recognized that fuel spurting was a hazard (CX 18; CX 64B; Coleman, Tr. 1601). IH knew that fuel spurting increased the risk of fire and that operators could be sprayed with gasoline (Coleman, Tr. 1004, 1018–19; CX 6B; CX 379, Ziskal Dep., pp. 22–23; RX 162). In fact, a fire was reported to IH as a result of fuel spurting on an IH gasoline-powered tractor in June 1950 (RX 160).

46. An engineering docket was opened to deal with the fuel spurting complaints involving the flat cap, and the Test and Development

Group was instructed to experiment with design alternatives (CX 1; Coleman, Tr. 1343). The engineering undertook **[21]** to duplicate the condition as reportedly experienced in the field (CX 1; Coleman, Tr. 1343–45). They then tested a host of different types of caps and experimented with fuel tanks containing a variety of internal baffling arrangements under the reported circumstances for the purpose of determining whether other designs would overcome fuel spurting (CX 1; RX 161; RX 163; CX 2; RX 166; CX 64A; Coleman, Tr. 1345).

47. In the course of their dealing with the fuel squirting problem, respondent's engineers were aware that the heating of the fuel in the fuel tank was causing pressure to build up in the tanks of the IH tractors (Coleman, Tr. 999, 1026; CX 379, Ziskal Dep., pp. 23–24).

48. By July 1954, IH developed and made available a fuel cap which reportedly eliminated fuel spurting by using a series of baffles in the cap (CX 64; Coleman, Tr. 1036). The cap was designed and tested by IH (CX 7; CX 11; CX 64; RX 17; RX 171; Coleman, Tr. 1405). The cap had the same size 1/16th inch vent hole used on previous production caps which vented through a hole in the top of the cap (Coleman, Tr. 1647, 1695). IH referred to the cap as the triple baffle cap (Coleman, Tr. 1037, 1393; Link, Tr. 1997; CX 64). IH believed, as a result of testing, that the triple baffle cap overcame fuel spurting and was otherwise satisfactory in field operation (CX 13). IH therefore marketed the triple baffle cap for use on all IH tractors, claiming it reduced fire hazards (CX 18; Coleman, Tr. 1040).

49. In 1954, when IH began marketing the triple baffle cap, IH knew that using the cap on IH gasoline-powered tractors did not lower the temperature of the gasoline in the tank to any significant degree (Coleman, Tr. 1040). IH also knew that the cap did not affect the rate of heat flow to the gasoline tank of IH gasoline-powered tractors (Coleman, Tr. 1041). IH further knew that the difference in either the rate of pressure build-up or the amount of absolute pressure in the tank was not great, as between the flat cap and the triple baffle cap (Coleman, Tr. 1046, 1398-1400; Sullivan, Tr. 5190).

C. *1955–1958*

50. By 1955, reports of fuel geysering incidents began to come to respondent's attention (CX 19A). By this time IH also was conducting tests to determine the amount of pressure build-up in the fuel tanks of its tractors, factors which influenced such pressure, and ways to deal with it (CX 16D-E; CX 17B; CX 19A; CX 20; Coleman, Tr. 1097). Although the amount of pressure build-up varied among these tests, IH knew in 1955 that factors present during the normal operation of its tractors, **[22]** such as engine heat, agitation of fuel in the tank, ambient air temperature and wind direction and velocity could sub-

stantially affect the vapor pressure build-up in the tank (CX 17A; CX 19A; CX 20A; Coleman, Tr. 1053–54, 1069; Link, Tr. 1986–87).

51. By 1955, it was also common knowledge among IH engineers that gasoline was being heated to the point of boiling (rapid vaporization) in the tanks of its gasoline-powered tractors (Coleman, Tr. 1055, 1069, 1072). IH was routinely obtaining temperatures of over 100°F. in its fuel tanks during the course of various tests (CX 16D-E; CX 17A-B; CX 19A-B). It knew, and had known for many years, that gasoline usually begins to boil, or vaporize, at approximately 96°F. to 97°F. (CX 16A-C; CX 379, Ziskal Dep., pp. 27, 33–34; Coleman, Tr. 1070; Creighton, Tr. 2271–72; Hurn, Tr. 3899–3900). It also knew that high gasoline temperatures in the fuel tank led to rapid pressure build-up (CX 16D-E; CX 17A; CX 19A; Coleman, Tr. 1088–89). IH further knew that a sudden release of that pressure from the fuel tank, as might occur on removal of the cap, could result in the boiling of the gasoline in the tank (Coleman, Tr. 1055) and even the ejection of fuel from the tank and the spraying of the operator with gasoline (CX 19A). (RRF 156). By this time IH had received "field complaints" stating that tractor owners had been "sprayed with gasoline when removing the fuel cap due to a pressure build-up in the fuel tank" (CX 19A).

52. By December 1956, IH management was aware of a number of reports received from the field that the fuel tank on the International 300 model tractor became excessively hot during field operation, causing the gasoline to boil. One of the reports mentioned a geysering incident which resulted in a fire, when the operator removed the fuel cap. (CX 24A; Coleman, Tr. 1104–05). These reports were submitted to the Farm Tractor Committee, which made policy decisions concerning IH agricultural equipment. The Committee was comprised of representatives from the Engineering, Manufacturing and Sales departments. (Coleman, Tr. 1104; CX 403D).

53. In January 1957, an incident occurred at the Harvester Farm (respondent's test facility) wherein fuel geysered from the filler neck of an IH gasoline-powered tractor when the operator removed the cap. This accident occurred while the tractor was operating on a belt dynamometer in an enclosed room with the fuel being supplied from a mobile storage tank, rather than the fuel tank.[6] As the tractor operated in the enclosed room the [23] temperature mounted and the fuel got hotter. The high ambient temperature and the heat from the engine caused the fuel to boil violently. The vent hole in the cap could not release the vapor pressure as fast as it was being generated by the

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[6] A dynamometer is a testing device which measures power or force. In this case it is an electrical generator which is connected to the engine. By varying the electrical load on the generator you can vary the load being put on the engine. The dynamometer has means for measuring the torque of the engine. By knowing the rotating speed you have the parameters to compute power (Coleman, Tr. 953–54). Thus it is used to study the performance of the tractor under varying loads, under laboratory conditions as opposed to field testing.

boiling fuel and there was squirting of fuel out of the vent hole. When the operator released the cap it was blown out of his hand. (CX 27B; Coleman, Tr. 1426–27). IH engineering recommended that a heat shield be used on all International "300" and "350" tractors to reduce heat flow and that a larger vent hole in the fuel cap, to reduce pressure, be considered. In connection with the latter recommendation they noted that the volatility of fuels would probably increase in the future (CX 27B).

54. Later in 1957, respondent for the first time received a report of personal injury resulting from a fuel geyser on an IH tractor. This was the Karl Bedke accident which occurred on August 10, 1957; a sunny day with temperature in the 90's. (CX 28A-B). The tractor involved was an I-300 utility tractor equipped with a center-tube baffle and an inertia-pin cap.[7] IH engineer R. N. Coleman investigated this accident in September 1957. Mr. Coleman concluded that a fuel geyser had occurred due to the sudden release of pressure in the fuel tank, [24] causing a solid column of fuel to be forced up through the cylindrical baffle inside the tank and up into the air directly above the filler neck. The fuel was blown back upon the operator and ignited, possibly by a cigarette. The operator was severely burned. (CX 28A).

55. Mr. Coleman had two hypotheses as to how the fuel cap came off, releasing the pent-up pressure in the tank. The first was that the fuel cap was improperly secured by the operator and that after pressure had built up in the fuel tank to 2 to 4 psi it was sufficient to force the improperly installed cap off the filler neck. This hypothesis was supported by Mr. Bedke's insistence that he did not remove the cap. (CX 28A). The second hypothesis was that Mr. Bedke did in fact remove the cap, releasing the pressure. This hypothesis was supported by Mr. Coleman's feeling that it was unlikely that the gas cap would be blown off and land in an upright position on top of the hood about 6 inches in front of the filler neck and, further, by Mr. Coleman's opinion that the odds were against having the cap improperly installed in a position where pressure can be built up and where it can still be blown off with a pressure of 2 to 4 psi. (CX 28A-B).

56. During the course of Mr. Coleman's investigation of the Bedke accident, he learned of another fuel geysering incident which occurred on an 1–300 tractor owned by the Pickett Sheep Company. Several employees of that company reported that the fuel tank runs

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[7] The triple baffle cap was not included on the I–300 Utility tractor and subsequent I–350 Utility tractors because the new cap was somewhat higher than the ordinary flat cap and Sales objected to its appearance. The fuel tank for these Utility models were therefore designed with a center-tube baffle, extending from the filler neck down into the tank, to prevent gasoline from sloshing up under the filler cap and resultant "fuel spurting". The center-tube baffle was discontinued and the triple baffle cap was installed on later production of I–350's, shortly after the Bedke incident (CX 29D). The inertia-pin cap had an inertia arm vent pin which was used on a flat cap to prevent squirting through the vent holes. This cap had two vent holes on the side, rather than one in the center as on the standard flat cap (Coleman, Tr. 1356–57; CX 3).

too hot on their I–300 and that they had smelled fumes while operating that tractor. On one occasion when one of their young operators complained of the fumes the fuel cap was suddenly removed and fuel "spewed" up out of the tank, but no fire resulted. (CX 28F).

57. Although tests conducted by IH earlier in 1957 had indicated that a fully secured gas cap could not blow off the filler neck (CX 28A-E) respondent undertook further tests following the Bedke incident, to assure itself that this was the case.[8] Within two to three weeks after Mr. Coleman returned from investigating the Bedke incident the engineers at IH's Test and Development Group undertook further testing to determine the venting capacity of the various fuel caps and whether a fully secured cap could "blow off." (Coleman, Tr. 1447; CX 31). In [25] these tests the tank of an I–300 tractor was removed from the tractor and immersed in a tub of water, where it was heated with live steam. The tests showed that the new triple baffle cap was superior to the standard flat cap and the inertia-pin cap in venting pressure from the tank. However, when the triple-baffle cap was removed after the pressure in the tank was lowered to 2.46 psi (from a high of about 3.84 psi) a column of gasoline geysered out of the filler neck to a height of eight feet.[9] Three and three-fourths gallons of the five gallons of fuel originally in the tank were lost (CX 31A-B). It should be noted that the rate of heat transfer to the fuel under these laboratory conditions was much higher than that experienced in field conditions and that the more volatile winter gasoline was used in the testing (CX 31A). However, this testing did again illustrate that fuel geysering could occur and the factors involved therein. In none of these tests did the fuel cap blow off the filler neck. (Coleman, Tr. 1445; Link, Tr. 2043).

58. Another geysering incident occurred in Wisconsin on April 16, 1958. The operator of the tractor, an I–300 model, was Arnold J. Fischer. The facts surrounding this incident are not in the record, nor can it be determined from the record just when this incident was reported to respondent. (CX 53; CX 220). It can be determined however, that IH had a closed file on this incident as of June 11, 1963. A memo of that date identifies the incident and IH's file number and indicates that Mr. Fischer was deceased. (CX 53). It cannot be determined from the record evidence whether or not Mr. Fischer died as a result of the fuel geysering incident.

59. As of May 1958, IH was aware of one, and possibly two, fuel

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[8] The earlier tests indicated that even a partially secured cap could not be blown off, if it had been turned on at least a quarter turn. However, these tests were conducted under laboratory conditions and not under field conditions where greater vibration might be present. (CX 28C).

[9] A 14-foot geyser occurred when the standard flat cap was removed with a pressure build-up of 4.42 psi (CX 31A, C; Coleman, Tr. 1128). The tests showed that the venting capacities of the standard flat cap and the inertia-pin cap were about the same (CX 31A).

geysering incidents which had resulted in personal injury—the Bedke incident and, possibly, the Fischer incident (Findings No. 54, 55, 58). It was also aware of at least several others where personal injury had not been reported (CX 19A; CX 24A; Findings No. 50, 52, 56). At least one of these reports indicated that a fire had resulted (CX 24A). A number of other complaints had been received concerning the boiling of fuel in the fuel tanks of IH's I-300 tractors during field operations (CX 24A). [26]

D. *1959-1963*

60. In 1959, IH learned of two more fuel geysering incidents which resulted in bodily injury. Those were the Ronald Frisch and Lyle Binder accidents (CX 36B; CX 40). There was also a fuel geysering incident on an I-300 tractor in April 1959, involving James Buatte of St. Mary's, Missouri, which resulted in serious bodily injury (Buatte, Tr. 147-49, 175). However, this accident apparently did not come to respondent's attention until suit was filed some years later (Coleman, Tr. 1216-20).

61. On May 4, 1959, respondent learned of the tractor fire involving Ronald Frisch, which occurred on that same date at a farm near Earlville, Illinois. Mr. Frisch was operating a Farmall-350 tractor equipped with a fuel gauge filler cap when the accident occurred.[10] Mr. Coleman was again assigned by IH to investigate the accident and did so on May 13, 1959. Mr. Coleman was informed that the accident occurred shortly after refueling and that the "fire started in an explosive nature." The fuel gauge filler cap was setting partially over the filler neck, but not secured, with the lower part (the float assembly) setting down in the tank during the fire. Mr. Frisch was severely burned. (CX 36A-H; Coleman, Tr. 1635). Mr. Coleman admitted during the hearing that when he wrote his report on this incident he "had some feeling" that Mr. Frisch may have removed the gas cap. In a later civil suit, Mr. Frisch alleged that his accident involved fuel geysering. *Frisch* v. *International Harvester Co.,* 33 Ill. App. 3d 507, 338 N.E. 2d 90 (1st Dist. 1975). Mr. Coleman, however, feels that this accident actually involved fuel splashing out of the tank as a result of the cap not being properly secured after refueling and that the fuel was ignited by some source other than the tractor itself, but he admitted in his report that the evidence was insufficient to give real substance to this feeling (CX 36B).

62. In September 1959, IH learned of the Lyle Binder incident. The accident involving Mr. Binder of West Bend, Wisconsin, occurred on

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[10] A fuel gauge filler cap was one which incorporated a fuel gauge. It consisted of a cork float mechanism attached to the triple baffle cap, which mechanism extended down into the fuel tank from the cap. There was a gauge on top of the cap. (RX 181; CX 26).

an I–350 tractor. Respondent's report of **[27]** this occurrence indicates that Mr. Binder removed the fuel cap after smelling gasoline fumes and that a tractor fire resulted. (CX 40). Mr. Binder's tractor was manufactured prior to the time that heat deflectors became factory-installed equipment on I–350 tractors. Later tractors of this model were so equipped. (CX 40).

63. Also in September 1959, Mr. Coleman prepared a report which was intended for use by the Zurich Insurance Company in an investigation being conducted by that company (CX 41). Zurich Insurance Company was the insurance company which handled IH's product liability claims (Coleman, Tr. 1160). In this report, which dealt with the I–300 utility tractor, Mr. Coleman stated that if pressure were generated in the I–300 utility tank by an abnormally high rate of heat application or through the use of more volatile gasoline, that solid fuel will be "squirted" out of the tank if the filler cap is removed.[11] He also noted that gasoline was becoming more volatile. (CX 41).

64. The Farmall–350 tractor involved in the Frisch accident went out of production in 1958 (RX 89H). In the late '50's and into the '60's, IH (and other tractor manufacturers) responded to farmers' demands for larger tractors with increased horsepower engines and greater fuel capacity. Introduced in 1958, IH's six-cylinder tractors had their fuel tanks in the conventional location, but some models were equipped with L-shaped tanks, which could hold more fuel than the tanks employed on earlier models. (CX 42). The new six-cylinder tractors were equipped with improved heat shields between the engine and fuel tank. They were also equipped with instrument-panel gauges, and with triple baffle caps. (Coleman, Tr. 1167–68; 1333, 1410; CX 219, RX 89H-I).

65. Respondent knew in the late 1950's, that the L-shaped tank affected the rate of heat transfer to the gasoline in the fuel tank and that this, along with the activation of the fuel in the tank when the tractor was in motion, was a factor in creating pressure in the fuel tank (Coleman, Tr. 1173–75).

66. By March 1960, Coleman reported to R. D. Barrett, Chief Engineer for 400 and 500 series tractors, that there was considerable correspondence dealing with service reports of gasoline boiling and squirting on Farmall 460 and 560 tractors **[28]** when used in the early fall with corn pickers (CX 42; Waechter, Tr. 1732–33). The 460 and 560 tractors had L-shaped tanks (CX 219A, M, N). IH knew that these problems were not caused by specification discrepancies in the fuel caps, but rather by the combination of heating of the fuel tank, fuel volatility and venting characteristics of the fuel cap and the way the

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[11] When Mr. Coleman here referred to fuel being "squirted" out of the tank he was referring to "fuel geysering" as described in the Complaint (Coleman, Tr. 1202).

corn picker fit around the tractor, trapping heat (CX 42; Coleman, Tr. 1671). Coleman testified that, in CX 42, unlike CX 41, the term "squirting" did not refer to fuel geysering, but fuel spurting through the cap vent hole (Coleman, Tr. 1166). However, he acknowledged that the same factors noted in this report were involved in fuel geysering (Coleman, Tr. 1168–71). IH did not conduct any follow up investigation to these service reports because it already knew the underlying causes (Coleman, Tr. 1170). Although Mr. Coleman concluded in his report that modifying the fuel cap would "require major changes in design concept which are not known even now," the Test and Development Group opened a docket dedicated to studying new concepts in fuel cap venting. In the meantime, the use of mounted corn pickers was declining due to the development of the combine (CX 42; Coleman, Tr. 1462–64).

67. The concerns reflected in CX 42 were not unique to IH. In a report of April 1960 addressed to "the tractor industry" generally, and circulated to many manufacturers besides IH, the Ethyl Corporation described an investigation it had conducted into the problem of gasoline evaporation losses from a tractor fuel tank. (CX 43B).

68. The particular model used in the Ethyl Corporation's study was an IH Farmall–560, which was representative of the state-of-the-art of gasoline-powered tractors at the time: "The investigation was carried out on a late model production tractor having a fuel system representative of current design practice" (CX 43E; *See also,* Den Besten, Tr. 1815–17).

69. The Ethyl Corporation recognized that a solution to the vapor loss problem would not only improve the tractor's fuel economy but also reduce the hazards associated with pressure in the tank (CX 43C). The Ethyl report emphasized some of the same factors identified by Coleman: use of increased volatility fuel, high ambient temperatures, and shielding of the tractor engine compartment by mounted machines and other devices (CX 43C). Like Coleman, the Ethyl engineers considered the possibility of enlarging the vent hole: "[i]t may appear that a large unrestricted vent, despite a small increase in vapor loss, would have merit in virtually eliminating spontaneous boil-up of the fuel when the cap is removed" (CX 43H). However, the Ethyl report recommended consideration of "corrective measures" such as "tank insulation, better shielding and baffling of the tank, and even a pressurized fuel system," but did not recommend any change in the size or number of cap vent holes. (CX 43R). **[29]**

70. The Ethyl Corporation report was received and reviewed by engineers in IH's Test and Development group (Coleman, Tr. 1187; Den Besten, Tr. 1788). In fact Mr. Den Besten, a member of that group, referred to this report as a point of comparison in a later report

of tests run by IH dealing with the same problems (CX 47; Den Besten, Tr. 1789–90)).

71. In June 1960, IH engineer A.F. Voss filed another report dealing with excessive pressure in the fuel tanks of respondent's tractors (CX 44A-B). In his report Mr. Voss stated:

> The problem of gasoline "boiling" and generating excessive fuel vapor in tractor fuel tanks has been with us for a long time.

He also stated:

> [W]e continue to receive field reports of accidents wherein owners or members of their families have been seriously injured by inadvertent ignition of gasoline gushing from the tractor fuel tank.

Mr. Voss noted that most complaints occurred in the Spring and were probably related to the use of more volatile winter fuels in warmer weather. He felt that excessive pressures were building up in the tank and that such pressure resulted "in noticeable vapor, or squirting of fuel from the vent hole, or if the fuel tank cap is removed, the tank will empty itself of gasoline." (CX 44A). He also noted that:

> Most field complaints make mention of the cap "blowing off."

However, he stated that the Test and Development group had not been able to substantiate such "blowing off" even with over 100 psi pressure in the fuel tank. (CX 44A).

72. Mr. Voss stated that some of IH's competitors used larger vent holes than did IH. This reduces pressures but is conducive to "sloshing" of fuel from the tank even in cold weather (CX 44A).

73. Mr. Voss recommended that IH test a fiberglass fuel tank and greater diversion of the fan blast as a possible answer to these problems (CX 44A-B). From the tone of CX 44A-B it is clear that Voss addressed a problem (boiling and excessive fuel vapor) which was known to peers and superiors at IH (RRF 191). [30]

74. In August of 1960, IH sent two of its employees, Fred Waechter, an engineer, and a Mr. Geggie of its St. Louis District Office, to investigate problems with a new I–460 tractor which had been reported by David Nichols, of Lebanon, Missouri (CX 45A; Nichols, Tr. 2096–98). Mr. Nichols originally made his complaints to his IH dealer in May 1960, but after hearing nothing further, he later contacted both IH directly and the National Safety Council, by letter, stating his problems (Nichols, Tr. 2096–98). Nichols' complaints included: excessive gasoline fumes emitted from the fuel cap which caused his son to become nauseated; excessive fuel tank pressure accompanied by

the noise of gasoline boiling; excessive fuel consumption due to vaporization; and a fuel geysering incident which his son had experienced when he removed the fuel cap (CX 45A; Nichols, Tr. 2092–98, 2103–05; Waechter, Tr. 1727–30). Mr. Nichols testified that he reported the fuel geysering incident to IH, along with his other complaints, but respondent maintains that Mr. Nichols only referred to the fuel boiling and other symptoms which he and his son had experienced (Nichols, Tr. 2103–05; CX 45A-B; Waechter, Tr. 1764). After IH's investigation, respondent fitted Nichols' tractor with an improved heat shield (CX 45A; Nichols, Tr. 2098–99, 2110–11; Waechter, Tr. 1731, 1743, 1769), but the tractor continued to boil even after the new shield was attached (Nichols, Tr. 2101–03). Mr. Nichols reported to an IH employee in a later visit to his farm that the heat shield had improved the conditions reported, but that the fuel in the tank would still boil "under the right conditions" (Nichols, Tr. 2101). He admitted, however, that he never did fill out a form he was provided for further report to the IH district office (Nichols, Tr. 2102). Moreover, he continued to use the tractor until he sold it in 1967 (Nichols, Tr. 2102).

75. IH engineer Frederick Waechter conducted a detailed investigation into fuel tank pressure build-up and related problems during the Spring and Summer of 1960 and reported the results in writing on September 23, 1960 (CX 46A-R; Waechter, Tr. 1732). Waechter had daily conversations with Mr. Coleman during the time he was conducting these tests and Coleman approved Waechter's report before it was distributed to various personnel in Test and Development, Design, and other members of IH's Engineering staff (Waechter, Tr. 1732).

76. Part of Waechter's investigation consisted of tests to determine the severity of, and to try to eliminate, "fuel gushing"—the term Waechter used to describe "fuel geysering" (CX 46A; Waechter, Tr. 1718). These tests were conducted under laboratory conditions by placing a fuel tank from a 460 tractor into a tub of water and applying agitation and heat (Waechter, Tr. 1751–52). Waechter was able to duplicate fuel geysering [31] when the fuel cap was removed with fuel tank pressure at 2 psi and the fuel tank three-quarters full. Fuel geysered 20 feet high, and fuel loss was seven gallons. (CX 46B). It is likely that Waechter obtained other fuel geysers as well, since he notes that geysering can occur at widely varying fuel levels (CX 46B). Although Waechter's tests were conducted under experimental conditions, Waechter concluded in his report that fuel geysering "could occur on production tractors at widely varying fuel levels when tank pressure exceeds 1 psi" (CX 46B).

77. In another set of tests, using tractors in both laboratory and outdoor track tests, Waechter confirmed previous findings that pres-

sures in the fuel tanks of IH's gasoline-powered tractors exceeded 1 psi (CX 46A, C, H, I, J, K, L, P and R). Although his tests were generally confined to the I–460 utility tractor, one test conducted on an F–460 Farmail tractor showed similar results (CX 46R; Waechter, Tr. 1735). At least one test showed that pressure exceeding 1 psi could occur even when using summer grade gasoline, but only at a much higher fuel temperature. The latter test was conducted with the production heat shield (CX 46J). Another test using summer grade fuel and an improved heat shield did not yield appreciable pressure in the tank (CX 46Q). When using winter grade fuel, pressures of over 1 psi were usually obtained with both the production heat shield and the improved heat shield (CX 46A, H, I, K, L, M, P and R). Waechter reported fuel tank pressure over 4 psi and believed that pressure could go as high as 5 psi or more (CX 46C, I).

78. Mr. Waechter's tests also reconfirmed IH's knowledge concerning the effect of agitation on fuel pressure build-up in the fuel tanks on its gasoline-powered tractors. His tests indicated that agitation increased fuel tank pressure from 50% to 100% and that such pressure would return to normal when agitation was stopped. (CX 46C). He also reconfirmed earlier findings concerning the effects of wind direction and velocity on fuel tank pressures (CX 20; CX 46D).

79. Waechter's tests also showed that the location of the fuel tank is a contributing factor to pressure build-up in the tank (CX 46D). The tests indicated that a tank location above the engine with a tight baffle between tank and engine is better than a location to the rear of the engine or partly above and partly to the rear, as in IH's designs at that time (CX 46D).

80. The Waechter tests also demonstrated that there was an extremely hot spot on the I–460 tractor at the right hand corner of the fuel tank, adjacent to the exhaust manifold. The effect of this hot spot was shown by comparing the I–460 with Ford's Model 641 tractor. After one hour of operation, with fuel tank temperatures nearly the same, pressure in the fuel [32] tank of the I–460 was more than three times greater than that in the Ford 641. (CX 46D).

81. Mr. Waechter also conducted tests to determine whether the production cap (the triple baffle cap) could be blown off the filler neck of the fuel tank (CX 46A; Waechter, Tr. 1736). He found that a production cap could not be blown off the filler neck even at 18 psi fuel tank pressure. He found that maximum fuel tank pressure was limited to 7–8 psi, the pressure at which IH's triple baffle cap would relieve (experience tang relief)[12] (CX 46B). He believed that field reports of

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[12] "Tang relief" occurs when the pressure becomes high enough to raise the cap up through the spring action of the tangs which hold the cap on the filler neck. When this occurs the seal between the filler neck and the gasket on the cap releases, allowing the pressure in the tank to escape beneath the cap (CX 27A).

fuel tank caps blowing off were, in fact, cases where the operator removed the cap and gushing (geysering) fuel carried the cap out of his hand (CX 46D).

82. Mr. Waechter also reported that the noise of boiling fuel and the whistle of escaping vapor is alarming to the operator of the tractor when the tractor is stopped after a hard run (CX 46D).

83. Because Waechter's investigation indicated that IH tractors could generate excessive fuel tank pressure, even when the improved experimental heat shield was used, he recommended that future tractor designs be such that maximum fuel tank pressure would not exceed 1 psi under the most adverse conditions of using winter fuel in high ambient air temperature (CX 46A). He also strongly urged that his proposed experimental heat shield be adopted for production tractors in order to reduce fuel tank pressures (CX 46A).

84. At the time Waechter made these recommendations in 1960, IH knew that it was possible to design tractors that would not generate excessive pressures. His report refers to two model tractors of IH's competitors, the fuel tanks of which are so located and insulated that pressure build-up presents no problems. (CX 46E, F). He does note some venting problems with each, however, in that one (the Massey-Ferguson 65) appeared to be subject to fuel spurting and the other (the John Deere 730) was subject to damage and blocking in the venting system (CX 46F). [33]

85. Through the end of 1960, IH continued to receive field complaints of gasoline boiling in its fuel tanks. Prompted by such reports, another IH engineer, Mr. Den Besten, conducted a further investigation into this problem of fuel evaporation losses from the fuel tanks of its tractors. (CX 47A). The report notes that the results of this investigation should be compared to those of a similar investigation conducted by Ethyl Corporation—the Ethyl Corporation report referred to in Findings 67 through 70, *supra* (CX 47A).

86. Den Besten's investigation was assigned the same docket number as the Waechter investigation, referred to above, and received similar circulation among IH officials (CX 46A; CX 47A). The report, dated December 12, 1960, found that gasoline evaporation from the fuel tank was a significant factor in fuel economy, as reported by Ethyl Corporation. As much as 6% of the fuel can be expelled via the fuel tank filler cap. It noted that the gasoline tank is heated by the radiator fan blast as well as by engine radiation. (CX 47A).

87. Den Besten tested a Farmall-560 tractor using winter grade gasoline. The tractor was belted to an electric dynamometer and operated under test conditions until the fuel supply was exhausted (CX 47A). The ambient air temperature in the room where the tests were conducted ranged from 105° F. to 110° F. during the greater part

of the tests (CX 47C). Fuel tank pressures in excess of 3 psi were generated (CX 47C, D). Den Besten recommended, based on his investigation, that consideration should be given, in designing future tractors, to a double-shell insulated tank, or relocation of the tank to a cooler position. He also recommended further investigation of the merits of a fiberglass fuel tank (CX 47A).[13]

88. In March 1961, a report of the Farm Equipment Tractor Committee (an upper-management level body) considered the recommendation of Mr. Waechter that his improved heat shield be installed on I–460 and I–560 tractors (CX 48D). The report states that "complaints have been received of gasoline boiling and spurting out of fuel tank during operation." It notes that although complaints of this sort were most prevalent with the I–460 tractor, that some complaints of this nature had also been received in connection with the Farmall–560 tractor. (CX 48D). It quotes Mr. Waechter's report of 9–23–60 as stating: [34]

> Gushing of liquid fuel can occur on the production tractor at widely varying fuel levels when tank pressures exceed 1 p.s.i. When tested at a fuel tank pressure of 2 p.s.i. with the tank 3/4 full, fuel gushed 20 feet high and fuel loss was seven gallons.

The Committee noted that although the experimental heat shield recommended by Test and Development gave significant improvement in fuel tank pressure, that it was still possible to have excessive fuel tank pressure even with this shield. (CX 48D). The Committee also noted that the "new-line" models of these tractors were already to be equipped with an improved heat shield. In light of these circumstances, and the "low" number of complaints received, it was the consensus of the Committee that the increase in product and equipment cost for the improved heat shield recommended by Waechter ($3.49 direct manufacturing product cost per unit) was not warranted. (CX 48D).

89. In the March 1961 report of the Farm Equipment Tractor Committee it was noted that there had been 11 such complaints received (about boiling and spurting) in connection with the I–460 and F–560 tractors—six in connection with the I–460 and five about the F–560 (CX 48D).

90. In February 1962, IH learned of another fuel geysering incident in which the operator was injured. At that time respondent's Fargo District Office reported that Gunnard Pearson had been injured in a tractor fire involving the fuel tank cap on a Farmall–450 tractor. (CX 49A, B). Respondent did not investigate the cause of this accident, so

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[13] Waechter had found that there were serious problems with fiberglass fuel tanks, particularly with the bonding of the filler neck to the tank. (Waechter, Tr. 1762–63; CX 46A).

the details are lost to this record (Coleman, Tr. 1603). A report to the insurance company, in evidence as CX 49B, merely recites some of the possible causes of such an accident. Several possible factors are mentioned which might cause a fuel geyser when the fuel cap is suddenly removed (CX 49B). It is also noted that this was the first such complaint received about an F-450 tractor, although approximately 25,500 of such tractors had been built (CX 49B). The last F-450 tractors had been produced in 1958 (*See* Finding No. 8, above).

91. By 1963, respondent started to get involved in litigation as a result of private suits seeking damages for injuries sustained in fuel geysering incidents. The Buatte incident, mentioned above in Finding No. 60, gave rise to the first of these suits (CX 52; CX 53). These suits gave rise to further testing by respondent's engineers and outside experts in preparation for such litigation (Coleman, Tr. 1217-18, 1220, 1606; CX 52; CX 53; CX 68; CX 69; CX 70). [35]

92. Mr. Buatte alleged that the fuel cap on his I-300 tractor was blown off and that fuel geysered out spraying him with gasoline and that he was seriously burned (CX 52; Buatte, Tr. 147-49, 175). Mr. Coleman conducted a field investigation and inspected the I-300 tractor, which was equipped with a center-tube baffle, a flat cap and no heat shield (Coleman, Tr. 1217-18, 1606). He concluded that Mr. Buatte must have removed the fuel cap, despite Mr. Buatte's statements to the contrary (Coleman, Tr. 1220). Mr. Coleman also felt that there must have been pressure in the gas tank of Mr. Buatte's tractor sufficient to cause the geysering of fuel out of the tank (Coleman, Tr. 1221).

93. An independent engineering consultant, Wayne Worthington, was consulted by respondent's local counsel at the suggestion of Mr. Coleman (Coleman, Tr. 1217). Mr. Worthington reviewed certain information forwarded by the local counsel and formed a hypothesis as to how the accident might have occurred. This hypothesis involved, among other things, Mr. Buatte's failure to properly secure the gas cap, spillage of gasoline when Mr. Buatte filled the tank shortly before the accident and ignition of fuel vapors under a cocked filler cap. (RX 27). After later consulting with Mr. Coleman and another independent expert, Professor J. D. Liljedhal, at the Harvester Farm, and reviewing certain internal IH documents and test results, as well as participating in certain experiments at the Harvester Farm, Mr. Worthington conceded that his original hypothesis was incorrect (CX 53A). He then concluded that Mr. Buatte had secured the filler cap only to the point where it sealed the gas tank against leakage, but could work loose. He opined that the gas cap could then be expected to "fly off" suddenly at some point of loosening. (CX 52A).[14] He further

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[14] Mr. Worthington admitted that he had never seen this occur and that such had not been demonstrated during

(footnote cont'd)

informed respondent that it was his opinion that tractors of this design—with center-tube baffles and no heat shield—were dangerous if certain necessary conditions were present. The necessary conditions were improperly secured cap, volatile fuel and sufficient heat (CX 52B). He characterized the I–300 tractor as including "a built-in accident" under these conditions (CX 52B).

94. In June 1963, IH officials and others involved in the Buatte litigation, including insurance company representatives, [36] also reviewed a number of files dealing with other incidents involving "similar allegations" (CX 53; Coleman, Tr. 1249). A memorandum for the file (CX 53) shows that IH then had seven files involving accidents occurring during the period August 1957 through May 1962 which were reviewed. Included were the Bedke, Fischer, Frisch, Binder and Pearson accidents mentioned above (Findings No. 54, 58, 61, 62, 90), as well as two additional accidents which occurred in May 1962 (CX 53). The one, involving a Mr. George Brittain, occurred in Wisconsin and the other, involving a Mr. Dale Storer, occurred in the area covered by respondent's Kansas City field office (CX 53). Although no details of these last two accidents are contained in the record, CX 53 refers to them as involving allegations similar to those in the Buatte incident. Although the memo refers in its heading to "Alleged Product Failure-Fuel Tank Cap Model 300 Utility Tractor," the incidents listed therein were not limited to the I–300 tractor. The listed accidents included incidents which also involved the I–350, F–350, and F–450 tractors. The record does not show what model tractors Messrs. Brittain and Storer were operating (CX 53; CX 220; CX 410).

E. *1964–1972*

95. Subsequent to his 1960 investigation (Findings No. 85–87), respondent's engineer, John Den Besten, and other engineers working with him, continued to investigate fuel tank pressurizing and ways to deal with it (CX 55–58). From 1960 to 1965, Mr. Den Besten continued his efforts to convince IH management and the Design group that the fuel tank on future tractors should be relocated so as to reduce fuel tank temperatures and pressure (Den Besten, Tr. 1798).

96. In March of 1964, his group reported on tests conducted on an I–606 tractor utilizing a venting system which consisted of a small diameter tube connected to the filler neck which ejected fuel spill-over and vapors downward below the fan blast. The tube had a valve on the end to eliminate excessive loss due to spill-over and evaporation. This venting system still provided a maximum fuel tank pressure of

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the testing at respondent's test facilities. This was his theory of the cause of the Buatte accident, based upon "extensive discussion." (CX 52A). Mr. Coleman had previously considered such a possibility in connection with the Bedke fuel geysering incident (CX 28A; Finding No. 55).

4 psi and allowed a 6% loss of fuel as vapors. (CX 55A). Using a larger diameter vent tube and eliminating the valve on the end, reduced the maximum fuel tank pressure to 1.7 psi, but the fuel vapor loss increased to 11.4% (CX 55A). The report states:

> In the interest of safety it may be necessary to further reduce fuel tank pressure. However, the customer must pay a severe penalty in fuel cost for this added safety (CX 55A). [37]

The report also noted that vapor lock became more severe when the larger vent tube was used (CX 55A). The report then recommended as follows:

> The laboratory has in past reports complained about excessive fuel tank temperatures of our six cylinder tractors. We believe this series of tests emphatically points out that on all future tractors, the fuel tank location must be changed.
>
> To correct the excessive fuel vapor loss *and/or the dangerous fuel tank pressures on our present production tractors,* we recommend that a docket be written to provide improved heat shield material. (CX 55B) (Emphasis added).

97. This group of engineers conducted similar tests on the F-806 tractor using the same sizes of vent tubing. The report on these tests was dated April 8, 1964 and revealed similar results. (CX 56A). This report makes the same recommendations for relocation of the fuel tank on future tractors and testing to develop improved heat shield materials for present production tractors (CX 56B).

98. In August 1964, Den Besten approved a report on further tests relating to fuel vaporization losses and tank pressure on respondent's gasoline tractors (CX 57A). This report concerned tests made with a Farmall-806 gasoline tractor pulling Model 47 and 37 disc harrows during field operations (CX 57A). These tests yielded maximum fuel tank pressures ranging from 4.3 to 4.9 psi, which the report characterized as:

> . . . constituting a definite safety hazard. (CX 57A).

99. In May 1965, Den Besten approved a report of tests conducted by another group of IH engineers which was concerned with the subject of fuel tank heating in connection with the preliminary planning of a tractor then under consideration for production—the TX-19 (CX 58). This model was the prototype [38] of IH's later "World Wheel Tractor" production (CX 59B).[15] It was addressed to a conferee to the

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[15] The World Wheel Tractors were planned, and later produced, for worldwide distribution, unlike previous tractors designed at IH's engineering center in Illinois which were planned and produced for distribution in only North America (McCormick, Tr. 1521-22).

World Wheel Tractor Committee (CX 58A; CX 59A). The report begins by stating:

> There has been considerable discussion and investigation on the subject of fuel tank heating. Preliminary layout of the TX-19 tractor locates the fuel tank above and behind the engine. In our opinion, the tank should be located behind the driver's seat. (CX 58A).

It stated further that:

> The shape and location of the fuel tank on the TX-19 tractor, subjects the tank to all the fuel heating and vaporization problems that have arisen on other IH tractors with similar design [the L-shaped tank located above and behind the engine]. (CX 58A).

The report further notes that the tank in such design is subjected to the heat of the fan blast and to radiation from the engine and, further, that cooling tests on other tractors indicate that the tank sheet metal temperature will approach the fan blast temperature after approximately four to five hours of operation (CX 58A).

100. CX 58 also states that the L-shape of the tank on the TX-19 tractor allows certain portions of the tank to be exposed (not covered by fuel) when operating with a partial tank of fuel. "These surfaces will quickly heat to the fan blast temperature, possibly 180° F. to 210° F. Fuel that is sloshed over these surfaces as the tractor operates in the field, will readily vaporize. Vaporization of the fuel raises the fuel tank pressures *which constitutes a safety hazard.*"(CX 58B) (Emphasis added). Mr. Den Besten testified that these problems existed on all IH tractors with the L-shaped tank. He said that such tractors included all of the six-cylinder [39] type tractors, which included the 460, 560, 660, 706 and the 806, as well as the 606 which later became the 656 (Den Besten, Tr. 1811).

101. Moreover, in connection with their recommendation that the fuel tank be relocated on the TX-19 and future production tractors, that group urged:

> The relocation position should be away from the extremely hot areas of the tractor since the Cooling Test Group feels that shielding and insulation of the tank in a hot area are only token measures in eliminating the over-heating problems. (CX 58A).

Mr. Den Besten testified on this record that at the time of this report the evidence indicated "that additional insulation would not have a substantial effect in reducing fuel tank temperatures or pressures" (Den Besten, Tr. 1794).

102. The World Wheel Tractor Committee considered the question of location of the fuel tank during the years 1965 and 1966. Over this period of time the Committee considered many pros and cons for

locating the fuel tank to the rear of the operator's seat, rather than in the conventional location above and behind the engine (CX 59; CX 71; CX 72; CX 73; CX 74; RX 182). The Committee ultimately decided to move the tank to the rear of the driver's seat on this line of tractors (CX 73; CX 74). Safety—possible fire hazard—was one of the factors which prompted the Committee to relocate the fuel tank on this line of tractors (CX 72; CX 73).

103. Although the fuel tank was relocated on the World Wheel line of tractors, IH continued to produce its North American tractors with the fuel tank located in front of the operator (CX 221).

104. In March 1966, respondent received a report of another operator who was injured in a fuel-geysering incident. Mr. Paul McClure of Gideon, Missouri was operating an F-706G tractor when the accident occurred. Mr. McClure reported that he heard a hissing noise and that fuel started spewing out of the vent and from around the filler cap. He stated that he immediately put the tractor in neutral and was preparing to jump off when he was blown off from an explosion. The report from IH's St. Louis office notes that the cap was found about 15 feet from the tractor (CX 61). The report also indicates that Mr. McClure's tractor had recorded only 34 hours of operation when this accident occurred (CX 61). IH engineers, after later testing, felt that the operator must have removed the cap, despite his statement to the contrary (CX 62). [40]

105. Shortly thereafter respondent received another report from Gideon, Missouri concerning an F-706G tractor that had experienced problems with excessive pressure in the gas tank. This tractor was owned and operated by a Mr. Robert Sanders. The pressure problem was apparently relieved satisfactorily by replacing the fuel cap with another from a Model 560 tractor which was operating in the same field. (CX 62).

106. By 1966, respondent was also preparing its defense to a lawsuit filed by Ronald Frisch for injuries resulting from his fuel geysering incident (CX 69A; Findings No. 60–61). In connection with this lawsuit, upon request of IH's counsel, certain engineering tests were conducted by IH engineers Robert Reed and William Shubert (CX 67; CX 68; CX 69; CX 70; Reed, Tr. 3018–19; Shubert, Tr. 1884). Upon advice of counsel, neither Reed nor Shubert discussed the findings of these tests with any other IH officials (Reed, Tr. 3019, 3030, 3060; Shubert, Tr. 1893). For example, Mr. Coleman, who testified and assisted counsel at the table during the *Frisch* litigation, was not aware of these tests until after the *Gauges* litigation, which began in 1978 (CX 400B; Coleman, Tr. 1255, 1258–63, 1273–75).

107. The Reed-Shubert tests revealed that the standard production cap (the triple-baffle cap), when only screwed on a half inch or less,

might unscrew and come off a running engine (Reed, Tr. 3022; CX 67A-B; CX 69; CX 70). In one test, using a float cap, with the engine running wide open, air pressure applied and pressure in the tank of 3.5 psi, the cap vibrated off even though it was screwed on to the distance of one inch (CX 68A). It took a turn of about three inches to fully secure the cap (CX 69B). Overall, the results of the Reed-Shubert tests were quite erratic (CX 67–70).

108. The Reed-Shubert tests also attempted to create a geyser (CX 67–70; Reed, Tr. 3024–30). The results of their tests in this regard indicated that pressure alone was insufficient to cause a geyser. The tests indicated that a combination of pressure in the tank and high fuel temperature was necessary to effect a geyser (Reed, Tr. 3024–30).

109. Additional tests were conducted in connection with the *Frisch* case by IH engineer George T. Rezek (Rezek, Tr. 3075–82). On the basis of those tests, which attempted to simulate the conditions claimed by Mr. Frisch, the engineers concluded that a properly affixed fuel cap could not be blown off the tractor during normal operations (Rezek, Tr. 3075–82).

110. In 1968, the test and development process was completed for the World Wheel tractor and they were released for production with rear-mounted tanks (McCormick, Tr. 1562). [41] Although initially conceived as a diesel-powered tractor, a small number of these tractors were equipped with gasoline-powered engines for sale in the United States (McCormick, Tr. 1538, 1549, 1570–71; CX 221C). By the end of the 1960's the majority of the tractors being built by IH were World-Wide (World Wheel) tractors with the fuel tank located in the rear (CX 221). This line of tractors was not alleged to have been involved in "fuel geysering" incidents (CX 220).

111. In 1968, respondent's engineers also continued testing ways to control gasoline vapors and pressures in the fuel tanks of its other models of gasoline-powered tractors. CX 79A-D reports on tests to determine whether gasoline vapors in a fuel tank could be controlled by a refrigeration process. For a variety of reasons this process was determined to be unsatisfactory (CX 79B).

112. Other tests were run that year (1968) on an I–656 tractor to investigate whether fuel tank temperatures could be reduced by circulating the fuel through a cooler mounted in front of the radiator. These tests also considered the effect on fuel temperatures of insulating the heat shield and fuel tank (CX 81A). Fuel temperatures were reduced by the fuel cooling system and stabilized at a temperature of 115° F. with a 95° ambient air temperature (CX 81A). The fuel temperature was further decreased and stabilized at 110° F. by installing a 2.75 inch extension along the bottom of the heat shield and applying insulation to the back of the shield. Scotfoam was applied along the

edge of the heat shield to form a tight fit between the shield and the hood. This prevented fan blast from travelling beyond the shield (CX 81A). The fuel cooling system was found to be unsatisfactory for several reasons (CX 81B), but further study was recommended on future designs of heat shields (CX 81B). The engineers concluded that a heat shield should not be made of a material that is capable of radiating heat to the fuel tank and that the heat shield must be able to prevent all the fan blast from contacting the fuel tank. They also found that the hood sheets are heat generators, as well as the fuel tank support. They recommended an investigation be made to control the heat flow to the hood sheets and the fuel tank support (CX 81B).

113. Tests to control fuel tank temperatures and pressures continued into 1969. CX 382, dated January 7, 1969, reports the results of tests on a Farmall–656 gasoline-powered tractor with the fuel tank coated with a rigid urethane foam. CX 83, dated June 5, 1969, reports on tests conducted with an underslung fuel tank. Both of these methods were found to have drawbacks and, therefore, were not put into production (Coleman, Tr. 1622–24; CX 83). [42]

114. In August 1969, however, one of the improvements tested, the insulated upper and lower heat shield assemblies and front hood assemblies, was released for production and service use on the Model 656 and 544 tractors (CX 84A-B).

115. In January 1969, respondent received a report that a Mr. Max Howell was burned when gasoline spurted out of the vent hole of his fuel cap and ignited. Mr. Howell was operating a Model 656 IH tractor. After his accident Mr. Howell traded his gasoline-powered tractor for a diesel tractor (Model 656). (CX 82). Although this was a fuel squirting incident, rather than a fuel geyser, it further illustrates the fuel temperature and pressure problems which IH was having with its tractors (Findings 42–112).

116. During the decade of the 1970's, IH's production of gasoline-powered tractors, which was already small in comparison to diesel-powered tractor production, dwindled to zero. This was part of an industry-wide shift to diesel in response to farmers' demand for more powerful and more energy-efficient tractors. By 1970, the vast majority of the gasoline-powered agricultural tractors being manufactured by IH were World-Wide tractors with rear-mounted tanks. By 1975, IH's production of gasoline-powered tractors with fuel tanks located above and behind the engine was down to only 1700. (RX 212). In 1976, 1977, and 1978 this production figure was down to 600, 300 and 80, respectively. No such tractor has been produced since 1978 (RX 212).

117. In April 1970, IH learned that David Didion of Bellevue, Ohio had been burned as a result of fuel geysering from the fuel tank of the 706 tractor he was operating (CX 89; CX 90; CX 91A-B). Mr. Coleman

investigated the Didion accident (CX 91A-B; Coleman, Tr. 1293). The various reports filed with respondent showed that Mr. Didion heard a hissing noise and noticed vapors escaping from the vent hole in his fuel cap. He then removed the fuel cap and gasoline spewed out and ignited (CX 89; CX 90; CX 91A-B). After the accident, the local IH distributor repaired the tractor and installed fiberglass insulation batting around the tank. David Didion's father, the owner of the tractor, then reported that gasoline vapors still came out the vent hole of the cap. The distributor then checked and adjusted the engine and put on a new fuel cap into which they had drilled a slightly larger vent hole. When Mr. Coleman visited the Didion farm he had the distributor install the insulation pad and the heat shield extension which were then in current production for the Farmall–656 tractor. The insulation battings previously installed by the distributor were left in place. (CX 91A-B). When Mr. Coleman visited the Didion farm, Mr. Ed Didion, the father, was absent. Word was left for him to contact Mr. Coleman at the distributors. After checking the [43] tractor and having the additional insulation and heat shield extension installed, Mr. Coleman waited at the distributor's until 6 P.M., but was not contacted by Mr. Didion. (CX 91A-B).

118. The Wendell Tietz fire also occurred in 1970. Tietz alleged that a blow-off had occurred on his F–656 tractor, which was built in October 1966. Mr. Tietz later filed suit and IH engineer George Rezek conducted a number of tests in connection with this litigation. Mr. Rezek's tests indicated that: a fully secured cap could not be blown off; a cap partially secured beyond a quarter inch turn could not be blown off; and a cap secured only one-eighth of an inch to a quarter inch may build up pressure and may be blown off. (Rezek, Tr. 3084, 3087–90). Mr. Rezek's tests also indicated that it would take an extraordinary amount of force to pull a fuel cap vertically off the filler neck (Rezek, Tr. 3085–87).

F. *1972–1982*

119. Prior to 1972, respondent did not have a separate product reliability organization. In that year it established the Product Reliability Group which brought together in one place all product reliability information (Bennett, Tr. 3141). Prior to that time there had been no central record keeping for such information and the responsibility for investigating safety problems was divided among different departments (Arp Dep., RX 257C-E, S-T; RRF p. 102, No. 543). Once established, the Product Reliability Group monitored the performance of product still under warranty, as well as the safety performance of all product, including older products in the field (Bennett, Tr. 3141–42). The product performance engineer in charge of monitoring the safety

performance of older product was James F. Bennett (Bennett, Tr. 3141–42). He was in charge of the Product Integrity Group which was a subgroup inside the Product Reliability Group (Bennett, Tr. 3143).

120. The Product Integrity Group collected records of accidents only back to 1969. There were a few records obtained concerning accidents prior to that time, but basically, the only records of accidents on older models in the field which this group obtained were those from 1969 and after. (Bennett, Tr. 3288–90). This was due, at least in part, to respondent's record retention policies (Borghoff, CX 278Y, CX 278Z–13; Bennett, Tr. 3290).

121. During the period 1972 to 1976, a few reports of fuel escaping through the filler neck came to Mr. Bennett's attention (Bennett, Tr. 3149). These included the Tietz, Ostendorf and Clowes incidents (Bennett, Tr. 3149–51, 3304–05). The Clowes [44] accident, which occurred in May 1972 on an F–656 tractor, occurred when Mr. Clowes removed the cap while the tractor was running and hot (Clowes, Tr. 1836–38). Mr. Clowes heard a hissing noise from the fuel cap while he was operating his tractor on a warm day. On previous occasions when he heard such a noise he had loosened the cap, letting out a puff of air and the hissing had stopped. On this occasion, when he did so, the gasoline geysered out, knocking the fuel cap from his hand and the gasoline ignited, burning him severely (Clowes, Tr. 1834–38).

122. Mr. Bennett was surprised when he heard that Clowes had removed the fuel cap from a hot and running engine. This was the first time Mr. Bennett had ever heard of an operator doing such a thing. (Bennett, Tr. 3304–05). Had Mr. Bennett had access to earlier reports from IH's files, he would not have been surprised (Findings 52, 53–56, 62–63, 71, 90, 92, 94, 104).

123. Another fuel geysering incident which came to Mr. Bennett's attention was the Junior Ostendorf fire which occurred in 1973. Mr. Ostendorf was operating an F–806 tractor. He filed suit against IH, alleging that the fuel cap blew off the filler neck. (Bennett, Tr. 3150–51). Respondent retained an independent expert, Professor Donald Hunt. Based on tests he observed at the IH testing facilities, Professor Hunt testified in that case that it was his opinion that the fuel cap had not been properly secured and that it vibrated off. (CX 291C-D, H-I). The only other possibility, in Professor Hunt's opinion, was that the fuel cap had been removed by Mr. Ostendorf, but the Court struck this latter hypothesis on the basis that there was no evidence that this occurred (CX 291H).

124. In August 1974, IH engineer George Rezek visited a dealer in Greenville, Pennsylvania to inspect a tractor owned by Ken Wood of Polk, Pennsylvania (CX 101B). Mr. Wood was badly burned in a fire which he alleged was the result of a blow-off. Mr. Rezek's investiga-

tion led him to conclude that the fire was the result of the operator's negligence and was not a blow-off. (CX 101A-B, E, F).

125. In December 1975, IH learned of a fuel geysering incident experienced by William Hartman of Pesotum, Illinois. Mr. Hartman was plowing with his 706 tractor and went in to refuel. When he removed the fuel cap, gasoline came out the filler neck. (CX 110; CX 138A-B). This incident did not result in a fire (CX 138A).

126. In 1976, IH learned of another alleged geysering incident, when Robert Gauges filed suit for injuries he suffered in a tractor fire which occurred on April 19, 1974. Mr. Gauges [45] was driving an F–756 tractor, which was built in June 1970. (Borghoff, Tr. 4022; CX 220D). Mr. Gauges claimed in his suit that the cap had blown off his fuel tank and that gasoline had geysered out (Borghoff, Tr. 4025–26). Mr. Borghoff, an IH engineer, concluded on the basis of his investigation and testing, and testimony in the *Gauges* and the later *Stambaugh* litigations, that a geyser did not occur and that the accident was caused by a windshield which was folded down over the vent hole of the fuel cap, the subsequent removal of the fuel cap by Mr. Gauges, and an in-rush of air into the tank, which caused gasoline to splash out as the tractor moved along (Borghoff, Tr. 4066–68; *Order Granting In Part Complaint Counsel's Motion to Strike Portions of Testimony of William Borghoff,* dated February 3, 1982, p. 2). However, respondent offered no substantiating evidence in this record to support this hypothesis (Borghoff, Tr. 4066–68).

127. Also in 1976, IH learned of the *Stambaugh* fire on a 706 tractor. The Product Liability Accident report indicates that the operator made similar allegations to those in the Gauges incident concerning a fuel geyser. (CX 111). This incident also later resulted in litigation in which a fuel geyser was alleged (CX 278).

128. Subsequent to 1976, Mr. Bennett and the Product Liability Group became aware of a number of other incidents involving claims of fuel fires or explosions on IH tractors. By early 1979, Bennett was aware of about 13 such incidents. (Bennett, Tr. 3154, 3326–27, 3415–16; CX 408A-F; CX 409A-B). These accidents with the year of occurrence in parentheses were: Buatte (1959), Frisch (1959), Howell (1968), Didion (1970), Tietz (1970), Clowes (1972), Gauges (1974), Wood (1974), Greathouse (1975), Ostendorf (1975), Stambaugh (1975), Biemeret (1976) and Laux (1978) (Bennett, Tr. 3302–03; CX 220A-H; CX 408C).

129. In May 1979, Mr. Bennett learned of the fuel geysering accident which occurred on an F–656 tractor operated by James Laux of Coldwater, Ohio. Mr. Laux told Mr. Bennett that he was baling with his tractor in the field when it started missing. He noticed a fine stream of gasoline spurting from under the fuel cap. He stopped the tractor in neutral, leaving it idling, and started reaching for the cap

with the intention of tightening it up. He didn't remember touching the cap, nor did he remember seeing the cap move, but he recalled seeing a column of gas going straight up out of the tank. He then started to jump off the tractor and was engulfed in flames. Mr. Bennett's report notes that the fuel cap could not be found after the accident. (CX 119A-B). [46]

130. In early 1979, while engaged in the early stages of the *Gauges* litigation, Bennett heard the contentions of plaintiff's counsel that there were more fuel geysering incidents than IH's Product Integrity Group was aware of. Against this background, Mr. Bennett had discussions with Messrs. Sullivan and Hillstrom.[16] Out of their discussions emerged the concept of the need for renewal of warnings disseminated to the field and a new attempt by engineering to address fuel geysering problems (Sullivan, Tr. 5149–54, 5186–89; Hillstrom, Tr. 3453; Bennett, Tr. 3155–56, 3327, 3416).

131. On March 30, 1979, Mr. Bennett wrote a note to Harlan K. Arp, then director of the Product Reliability Group (Bennett, Tr. 3155–56). The note stated:

> Apparently more people than we realized are removing gas caps while tractors are running. Even tho[ugh] this is cautioned against in op[erator] man[ual]s and all general safety material, I think we should put out another info bulletin specifically warning about the hazard this creates. Perhaps something along the lines of a facts brochure for dealer hand out to customers. (CX 116).

By note of April 6, 1979, Mr. Arp replied, agreeing with Mr. Bennett's suggestion and stating, "Lets try and put together a program that gets this message to customers as well as our own Regions and Dealers" (CX 116). This was the beginning of the idea for the Fuel Fire Prevention Program discussed below in Findings 167 to 261.

132. In April-May 1979, additional accidents involving allegations of fuel geysering were brought to the attention of Bennett's group. This brought the total known to them to about 30. (Bennett, Tr. 3324, 3327, 3416–17). Some of these accidents had occurred prior to 1969, and had been known to IH previously, but were not known in the Product Reliability and Integrity Groups or recorded in any of the documents assembled by that group in 1972 (which only went back to 1969) (Bennett, Tr. 3289–91, 3324–25). [47]

133. In November 1979, respondent learned of another fuel fire on an F-756 tractor in which Vernon VandenHoek was burned (CX 140A-B; CX 144A-B). This accident had occurred in October 1978. Mr. VandenHoek had been operating his tractor most of the day. It had been running hot. At about 4:00 P.M. he stopped the tractor and shut

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[16] Mr. Sullivan was IH's Manager of Safety and Value Engineering. Mr. Hillstrom worked under him and was in charge of product safety engineering (Sullivan, Tr. 5116; Hillstrom, Tr. 3437–40).

it off. After about a minute he removed the fuel cap to relieve the pressure in the tank. Some gasoline erupted. He replaced the cap and started to get off the tractor when he heard two explosions and then noticed fire. Mr. Borghoff's report of his investigation indicated that one of the explosions might have been the sound of gasoline igniting and the other might have been an engine backfire (CX 144A).

134. Up through 1981, respondent continued to learn of incidents involving other allegations of fuel geysers on various models of its gasoline-powered tractors (CX 149; CX 220A-K).

VII. RESPONDENT'S WARNINGS AND THEIR SUFFICIENCY IN LIGHT OF ITS KNOWLEDGE

A. *The 1940's and Early 1950's*

135. The earliest operator's manuals for IH gasoline-powered tractors contained a warning against filling the fuel tank around sources of ignition such as a running tractor (RX 2B). For example, the 1945 manual for the Farmall-"M" states, under the heading "Operating Precautions," as follows:

> SAFETY FIRST! Never fill the fuel tank when lamps are lighted, when near an open flame, or when the engine is running. When pouring fuel, keep the funnel and container in contact with the metal of the fuel tank (see Illust. 12) to avoid the possibility of an electric spark igniting the gas. Do not light matches near gasoline as the air within a radius of several feet is permeated with a highly explosive vapor (RX 5–3).

The 1945 manual also admonished that the fuel cap vent hole "should be kept open at all times to assure proper flow of the fuels" (RX 5–3). On a page bearing the "Universal Safety" symbol and the heading "Accidents can be prevented with your help," the 1945 manual contained "Rules for safe tractor operation," which rules were prepared by the Farm Safety Committee of the Farm Equipment Institute and approved by the National Safety Council (RX 5–5). One of these rules was "Never [48] refuel tractor while motor is running or extremely hot" (RX 5–5).[17]

136. Beginning in 1947, IH operator's manuals contained not only the "Safety First!" paragraph quoted in Finding 135, but also an illustrated cartoon stressing that the operator should wait until the tractor cools off before refueling (RX 7–3). This cartoon and the language quoted in Finding 135 was the basic format throughout the 1950's and early 1960's for IH's Farmall and Utility tractor operator's

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[17] Operators manuals were provided with new tractors. They were also available through IH's dealer network for purchase by owners of used tractors and others who may not have a copy (Heyen, Tr. 5475–76; Borghoff, Tr. 4141). However, one IH dealer estimated that from one percent, up to a maximum of thirty to forty percent of his customers who bought used tractors received operator's manuals (Heyen, Tr. 5475–76). Mr. Borghoff, IH's Manager of Product Integrity, testified that dealers do not generally stock a supply of operator's manuals, especially for older models (Borghoff, Tr. 4141).

manuals (*See, e.g.*, CX 269Z16–17). In certain manuals, there was also a caption under the cartoon ("Never refuel the tractor while the engine is running or extremely hot.") and/or the National Safety Council's "Green Cross for Safety" next to the "Safety First!" paragraph (CX 270E; CX 339E; CX 351F; CX 352E; CX 343E; RX 26–11). The "Green Cross for Safety" signified National Safety Council approval of any message that was accompanied by the emblem (Swanson, Tr. 4788).

137. These early manuals did not warn against removing the fuel cap while the engine was running or hot, nor was there any mention of fuel geysering, or a like phenomenon, as a possible result of such action (RX 5–5; RX 7–3; CX 269Z-16–17; CX 339E; CX 351F; CX 352E).

B. *1955–1958*

138. During the period 1955 to 1958, an unspecified number of field reports came to respondent's attention concerning fuel geysering incidents, in which it was believed that the tractor owners had removed the fuel caps from a hot or running tractor (Findings No. 51, 52, 54, 55 and 56). It had also experienced a fuel geysering incident at its own test facilities at the Harvester Farms, under experimental conditions (Finding No. 53). The evidence reveals that by 1958 respondent was aware of at [49] least two incidents where the gasoline was ignited, and at least one incident where the operator was injured (Findings No. 52, 54). In view of the fact that over 150,000 IH gasoline-powered tractors had been produced and sold prior to 1958 (RX 89H) the incidents which had come to respondent's attention by 1958 probably did not represent an alarming situation. However, these reports, along with knowledge it had acquired through the tests which it had been running before and during this period, did put it on notice that a potentially serious safety hazard existed (Findings No. 43, 44, 47, 49, 50, 51, 53, 57).

139. In 1958, respondent reacted to this knowledge by issuing two communications to its dealer network—a "Service Bulletin" in January 1958, and a "Service Slant" in May 1958. (Findings No. 143–145, below).

140. Documents known as "Service Slants" were used to communicate urgent or especially important information or when IH's service section wanted to highlight vital information with respect to which dealers were to take action (Coleman, Tr. 1455, 1461–62; Hartzell, Tr. 2946). Relatively few Service Slants were issued in any given year, thereby emphasizing the importance of their messages. A master copy of any given Service Slant would be sent first-class mail to IH's district managers, each of whom would then mimeograph copies and

mail them to the appropriate dealers in their respective districts (CX 204B; Coleman, Tr. 1449–51).

141. Documents known as "Service Bulletins" were used for more routine messages and as more formal announcements of the information transmitted to the dealers via "Service Slants." Service Bulletins were printed in bulk and shipped via truck to IH's district offices. This consumed more time than the handling of a Service Slant. (Coleman, Tr. 1131; Hartzell, Tr. 2980; CX 204C). They were then provided to the dealers. Typically, the Service Bulletins were circulated among dealership personnel who then could pass on any relevant information to their customers. (Gast, Tr. 3750–53, 3778; Hill, Tr. 3839–40; Jacoby Dep., CX 396C; Purdy, Tr. 3815–16). It was understood by IH service personnel that urgent messages would not be communicated through service bulletins (Hartzell, Tr. 2981). Although there is no regular pattern and the number received at any one time may vary, a dealer receives a large number of Service Bulletins. They may arrive 20 at a time (Gast, Tr. 3771). The district offices hate to receive Service Bulletins because they present so much work. They usually are not processed the day they are received in the district office. (Hartzell, Tr. 2980). **[50]**

142. Dealers have a great deal of discretion in handling service slants and bulletins. When a dealer receives a service slant or bulletin, he decides whether the information contained in it is applicable to his customers and how, if at all, to transmit the information. (Gast, Tr. 3750–52, 3778; Hill, Tr. 3839–40; Jacoby Dep., CX 396C; Purdy, Tr. 3815–16). A dealer can delegate this discretion to his employees (Jacoby, Dep., CX 396C-D). IH intends that the dealers could transmit the information "in whatever fashion they saw fit" (Waechter, Tr. 2999; Jacoby Dep., CX 396C-D). Dealers generally do not send service slants or bulletins to their customers (Gast, Tr. 3750–53; Purdy, Tr. 3813; Heyen, Tr. 5472–73; Hill, Tr. 3858).

143. The January 1958 Service Bulletin set forth specifications for seasonal fuel use, explained the correlation between Reid Vapor Pressure (RVP) and fuel volatility,[18] emphasized the greater volatility of winter-grade gasoline, and cautioned against the pressure build-up that could be caused by volatile gasoline out of keeping with the season of use. It did not warn specifically about fuel geysering, but did mention some of the possible consequences of out-of-season use of winter-grade gasoline, such as, excessive evaporation losses of fuel, pressure build-up in the fuel tank and percolation of fuel in the carburetor (CX 34).

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[18] The Reid method of vapor pressure testing is one measure of the volatility of gasoline, wherein the pressure exerted by the vapors of the fuel in a confined space and under controlled temperatures are measured in pounds per square inch (psi) (CX 34C).

144. Service Slant #24–58 was then issued in May 1958. After referring to the earlier Service Bulletin (Finding No. 143) about fuel volatility and seasonal changes thereof, this Service Slant explained some of the problems of using the more volatile winter-grade gasoline under warm weather conditions. It specifically noted:

> Due to rapid evaporation of this fuel on warm days, more vapor will be produced in the tractor fuel tanks than can escape through the filler cap vents resulting in pressure build up within the tank. This will result in higher fuel bowl liquid levels in the carburetor effecting [*sic*] fuel-air mixture and economy. The hiss of escaping vapor from filler cap vents is an indication [51] of pressure build up in the tractor fuel tank; removal of the filler cap should not be attempted until the pressure has dropped and the tractor cooled down. A quick release of pressure from the tractor fuel tank by the operator's removal of filler cap will result in a temporary effervescence of fuel, this in the presence of a hot engine or other means of ignition can be a fire hazard. Refer to Operator's Manual - Warnings against refueling a tractor while the engine is hot or while the engine is running. (CX 35; RX 22).

145. The engineers who drafted Service Slant #24–58 felt that "effervescence" was the best word to describe the entire range of problems which an operator might encounter upon removing the cap from a hot or running tractor (Coleman, Tr. 1137–38, 1452–53; Waechter, Tr. 3001). Although "effervescence" does not convey a message commensurate with a number of fuel geysering incidents mentioned in this record (Buatte, Tr. 149, 177; Cameron, Tr. 401; Didion, Tr. 675, 680; Kangas, Tr. 507, 550–52; Wohletz, Tr. 634; Shawback, Tr. 583; Coleman, Tr. 1138, 1670; Link, Tr. 2024; Hartzell, Tr. 2972, 2985; Gast, Tr. 3814; Borghoff, Tr. 4154; Borghoff Test. in *Stambaugh* case, CX 278Z–7–8), the message conveyed by this Service Slant was probably adequate in view of the state of IH's knowledge of the situation as of May 1958. Although it was aware of the existence of a potentially serious safety hazard, the record only shows knowledge at this point in time of two accidents wherein fire resulted and one in which the operator was injured. (Finding No. 138, *supra*).

C. *1959–1963*

146. In 1962, IH first published a Tractor Maintenance and Tune-Up Manual (RX 25) which was prepared by its tractor service supervisor, Harrison Hartzell, with the assistance of the University of Georgia (Hartzell, Tr. 2959–61). IH engineer Waechter also participated in its preparation (Waechter, Tr. 2993). This manual was designed to be used by servicemen and tractor users (Waechter, Tr. 2994). This manual, and its later reprints, were given away to farmers and agricultural colleges and used by dealers in informal meetings such as [52] "smokers" (RX 222; Hartzell, Tr. 2960–61). In 1962, several

thousand copies were distributed (Hartzell, Tr. 2984).[19]

147. The Tractor Maintenance and Tune-Up Manual contained a section on fuel volatility, which repeated the language from the 1958 Service Slant, quoted above in Finding No. 144 (RX 25Z-11-12).

148. In 1963, when respondent introduced a new line of tractors (the 806 model), the operator's manual was changed to state that the fuel cap was not to be removed from a hot or running tractor (Waechter, Tr. 2995-97; RX 26-21; RX 26-78). This warning was put under the heading "Filling The Fuel Tank," or "Preparing The Tractor For Each Day's Work" in the 806 and subsequent operator's manuals (RX 26-21; RX 26-118; RX 26-209; RX 48C). The operator's manuals for earlier models were not so amended (RX 2; RX 5; RX 7; RX 26-11; CX 269; CX 270; CX 339; CX 343; CX 351; CX 352). In fact, several of these manuals were reprinted as recently as 1979 without the addition of this language, or any other citation related to fuel geysers (CX 269Z-115; CX 339J; CX 352K).

149. Respondent's actions in distributing the Tractor Maintenance and Tune-Up Manual in 1962 and strengthening the wording of the operator's manuals for later model tractors in 1963 was insufficient in view of respondent's knowledge at the time. Since 1958, further reports of fuel geysers and injuries resulting therefrom, as well as greater knowledge of the underlying causes, had been coming to its attention (Findings No. 60-94). By June of 1960, IH engineer A. F. Voss had reported that:

> The problem of gasoline "boiling" and generating excessive fuel pressures in tractor fuel tanks has been with us for a long time. (CX 44A).

and that:

> [W]e continue to receive field reports of accidents wherein owners or members of their families have been seriously injured by inadvertent ignition of gasoline gushing from the tractor fuel tank. (CX 44A). [53]

In 1963, IH was also warned by an outside expert that it had retained in connection with the *Buatte* litigation that an improperly secured gas cap might loosen and "fly off," giving rise to a fuel geyser under some circumstances (Finding No. 93). (As early as 1957, Mr. Coleman had hypothesized that this might occur, in connection with the Bedke incident (CX 28A)). This, coupled with the persistent claims from operators that their fuel caps had "blown off" (CS 44A), should have caused respondent to question whether the warning in the Tractor Maintenance and Tune-Up Manual was sufficient, even if it could consider its dissemination as being broad enough, which it could not—*see* Finding No. 151, below.

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[19] IH was aware of the fact that farmers do much of their own tractor maintenance work (RF 411; D. Jolicoeur, Tr. 756; Allen, Tr. 3690-91).

150. The strengthening of the wording in the 806 manual suffered this same defect and more. It did not specify any possible results of cap removal, as did CX 35 and RX 25. Then, it too failed to caution about properly securing the fuel cap. Furthermore, the amendment would not reach the owners of older model tractors whose manuals were not to be amended. (RX 89H-I). This was so even though IH felt that tractor maintenance played an important part in fuel geysering incidents and that older tractors were more likely to be poorly maintained (Allen, Tr. 3690–91).

151. By this time, 1962–1963, IH knew that it had a serious problem on its hands. It knew that the temperatures of gasoline in its fuel tanks and the pressures therein were reaching high enough levels that a geyser could occur, if the fuel cap were removed or dislodged when the engine was running or hot. It knew too, that operators were removing fuel caps from hot or running tractors. In fact, it knew that its own test personnel were acting in this manner. Also, it had reason to believe that an improperly secured cap might vibrate off, precipitating a fuel geyser. (Findings No. 34, 50–66, 71, 73–93). By March of 1961, and since 1958, IH had been aware of at least 11 reported fuel geysering incidents on its I–460 and F–560 tractors alone. (CX 48D; RX 89I). Other reports had been received since 1958 concerning fuel geysering on other model tractors, some involving serious injuries (Findings No. 58, 59, 60, 61, 62, 71, 74, 85, 88, 90–92, 94). These, added to the unspecified number of reports of fuel geysers it had received between 1955 and 1958 (Findings No. 50, 52, 53, 54) gave notice to respondent that its Service Slant of 1958 (Finding No. 144) was insufficient to alleviate this hazard. The passing on of messages from Service Slants and Bulletins was discretionary with IH's independent dealers (Finding No. 142). Therefore, this was a haphazard way, at best, to put out such an important warning. The additional accidents since 1958 put IH on notice that its dealers were not getting the hazard warning to the operators of its tractors in [54] their service areas (Gast, Tr. 3774–75; Heyen, Tr. 5484–85; Hill, Tr. 3858–59; *See also,* Finding No. 154, below). In fact, it knew that many operators of used tractors might not even be regular customers of its dealer network (Gast, Tr. 3754–55). Since a Service Slant, which was supposed to be reserved for vital information (Finding No. 140) had proven ineffective, respondent could not expect the Maintenance and Tune-Up Manual to do more. The Manual was a much larger document, dealing with many different things, with the message from the Service Slant buried back on the thirty-sixth page. (RX 25). At least the Service Slant had dealt with only one principle topic and had given

some prominence to the caution against removing a fuel cap from a hot or running tractor (Finding No. 144). As for the new operator's manual warning of 1963, even in the unlikely circumstance that respondent still had reason to believe that operators carefully read the entire manual, it did not specifically warn of the hazard of fuel geysering and the vast majority of gasoline-powered tractors manufactured by respondent were not covered, as they were older models for which the manual was not revised (Finding No. 148).

D. *1964–1972*

152. During the rest of the 1960's and the early 1970's, respondent's actions with regard to this matter continued in the same vein, despite the fact that its awareness of fuel geysering as a safety hazard continued to grow. (*See* Findings No. 98 and 100, for example). During the period 1964 to 1972, respondent took several additional steps to communicate safety precautions to the operators of its tractors. None of these really went beyond the steps it had taken through 1963. During this period it:

(a) From 1964 to December 1975, inserted in its operator's manuals a National Safety Council bulletin entitled "Mr. Farmer" which cautioned the operator not to refuel a tractor when the engine was running or hot and directed the operator to read the operator's manual for other safety instructions (RX 155A-B).

(b) Conducted service training schools for its district service personnel where, among other things, the district personnel were instructed in the differences in volatility between winter-grade and summer-grade fuel and were given a demonstration of how heat and agitation can cause highly volatile gasoline to generate significant amounts of pressure in the tanks (Hartzell, Tr. 2962–64, 2977–78). The district personnel were directed to carry the message out to the dealer organization (Hartzell, Tr. 2964).

(c) Repeated the warning message of its 1958 Service Slant in a Service Bulletin which was distributed to the dealer [55] network through its district offices (CX 80A-D; Waechter, Tr. 2998–99; Hartzell, Tr. 2965–66).

(d) In 1971, IH developed a "Farm Equipment Safety Teaching Kit" designed for use in instructing high school age children about farm safety (CX 204E; CX 204Z48–Z49; Bennett, Tr. 3271). Availability of the kit was advertised in a variety of farm trade magazines, and IH offered the kit free-of-charge to Vo-Ag instructors, 4–H clubs and Future Farmers of America organizations (CX 204E; Bennett, Tr. 3271). As of 1977, approximately 9,000 kits had been distributed (CX

204E). The kit included a warning to refuel only when the tractor engine was cool (CX 204; CX 204Z48).

(e) In 1972, published a brochure entitled "18 Ways to Make Fieldwork Safer" (RX 37B-E; RX 266A-D; CX 204F, Z54–Z55; Bennett, Tr. 3272). Among other things, this brochure warned that a tractor should be refueled only when the engine is cool; the brochure also stated: "Stop tractor engine and let it cool before refueling. Be careful not to overfill tank or spill fuel on a hot engine. No smoking near fueling areas" (RX 37D; CX 204Z55). "18 Ways to Make Fieldwork Safer" was distributed to IH dealers with instructions to make it available to farmers (RX 37A; Heyen, Tr. 5495–96). "18 Ways" also appeared in IH's house magazine, *IH Farm* (the predecessor of IH's *Farm Forum*) (RX 37A).

Through 1972, respondent continued to receive reports of fuel geysering incidents and conducted further tests which indicated the unlikelihood that a mechanical solution (such as better shielding, better material for the fuel tank or better venting and cooling systems) could be found for the fuel geysering problem (Findings No. 95–121). This additional information and the continued lack of effectiveness of its normal communications channels (through its dealer network and its operator's manuals) should have prompted IH to make a more direct effort to warn tractor operators of this peril.

153. Moreover, this should have been quite obvious to respondent by this time. Accidents were continuing to occur despite its efforts (Findings No. 104, 105, 117, 118, 121; CX 220). This alone should have put it on notice that operators were not thoroughly reading the operator's manuals and that dealers were not passing on its warnings concerning removal of the gas cap. In the first place, IH knew that many of the gasoline-powered tractors in the field had changed hands a number of times and that many owners, as well as renters, did not even have an operator's manual (Buatte, Tr. 152; Greathouse, Tr. 194, 224; Cameron Tr. 372; Kangas, Tr. 487; Wohletz, Tr. 632; D. Jolicoeur, Tr. 755; Heyen, Tr. 5475–76; Borghoff, Tr. 4141). Secondly, it knew that the manuals for its older **[56]** models did not even contain a warning against cap removal (Finding No. 148). Finally, it also knew, or should have known that many operators, because of their great familiarity with tractors and tractor maintenance, don't read operator's manuals from cover to cover and are unlikely to read sections of the manual dealing with refueling procedures and the handling of fuel (Greathouse, Tr. 194; Kangas, Tr. 489, 494, 521, 550; Shawback, Tr. 587–88; Wohletz, Tr. 627; Didion, Tr. 670–71; Holtz, Tr. 714–15; D. Jolicoeur, Tr. 755; Clowes, Tr. 1827, 1830; Nichols, Tr. 2091; Borghoff, Tr. 4141; Swanson, Tr. 4861; RX 32, pp. 85–86). In fact, a Department

of Transportation report in 1971, giving the consensus of a number of university personnel concerned with operator elements of tractor safety, stated that too few operators bother to read the manual in sufficient detail (RX 32, pp. 85–86) and IH official William Borghoff testified in private litigation in 1979 that he believed about half of the people who operate IH gasoline-powered tractors do not read the operator's manual (Borghoff, Tr. 4140).

154. As for communication of warnings through its dealer network, respondent was also aware of deficiencies in this method of conveying a warning message. As noted in Finding No. 142, above, dealers have a great deal of discretion as to whether a particular message in a Service Slant, Service Bulletin, or other communication should be passed on to their customers. No IH dealer who appeared herein testified that he had ever undertaken to warn his customers about the hazard of fuel-geysering prior to the Spring of 1980, and some testified directly that they had not done so (Gast, Tr. 3774–75; Heyen, Tr. 5484–85; Hill, Tr. 3858–59).[20] One dealer said that, prior to 1980, he would not have passed on the information in Service Slant #24–58 concerning the danger of fuel "effervescing" upon removal of the fuel cap, since he did not consider this a problem in his area (Purdy, Tr. 3815–16). It should have been obvious to IH that unless it convinced its dealers that a very definite safety hazard existed, that in the exercise of their discretion the dealers would not pass on this message. The continuation of fuel geysering incidents was concrete evidence of this fact. Furthermore, IH was also aware that many owners of used tractors were not on the dealers' mailing lists and might not be easily located by the dealers (Gast, Tr. 3754–55, 3763–64, 3773–74; Purdy, Tr. 3807–08, 3812). [57]

155. In 1979, the Product Reliability Group of IH (which was founded in 1972) came to the conclusion that the facts as they then knew them warranted more specific warnings that get the message "to customers as well as our own Regions and Dealers" (Finding No. 131). Yet IH knew far more about this problem, and was aware of a far greater number of fuel geysering incidents by the 1960's, than Mr. Bennett and Mr. Arp were aware of in the Spring of 1979. In early 1979, Mr. Bennett was only aware of 13 incidents involving claims of fuel fires or explosions on IH tractors (Finding No. 128). The Clowes accident which occurred in 1972 gave rise to later litigation in which Mr. Bennett became aware for the first time that an operator might remove a cap from a hot or running engine (Finding No. 122). Yet IH knew as early as 1955, that operators were acting in this manner

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[20] Nor is Mr. Heyen's testimony in this regard muted by his further testimony that he would not have considered the Service Slant message concerning fuel cap removal to be new information, so as to warrant his communicating the message to his customers (*See* RRF 365). Mr. Heyen also was unaware of the number of fuel geysering incidents which had occurred in his homestate of Illinois—at least 18 according to CX 220.

(Finding No. 51) and this knowledge was reconfirmed in many reports through the latter half of the 1950's and the 1960's and the early 1970's (Findings No. 52, 53, 55, 56, 61, 62, 63, 71, 90, 94, 104, 117, 118). In fact IH knew that its own personnel at its test facilities sometimes removed fuel caps from hot or running engines (Findings No. 34, 53). In the 1960's, IH was also well aware that the pressure build-up in its gasoline-powered tractors with fuel tanks in front of the operator was excessive and constituted a very definite "safety hazard" (Findings No. 50, 51, 52, 53, 54, 57, 59, 60, 62, 63, 65, 71, 74, 76, 77, 78, 85, 88, 89, 90, 91, 94, 96, 98, 99, 100, 101, 102, 104, 115, 117, 118). In fact some reports of IH engineers specifically referred to such pressure build-up as a "safety hazard" (CX 57A; CX 58B).

156. Thus, during the 1960's and early 1970's respondent was far more knowledgeable about the hazard of fuel geysering than Mr. Bennett and his associates were in 1979. It also knew that these incidents were continuing despite its efforts through normal channels of communication to warn operators not to remove the cap from a hot or running tractor (Findings No. 50–118, 153–54). It also had at least two warnings that an improperly secured cap might come loose precipitating a geyser (CX 28A; CX 52A), along with repeated allegations from operators that their fuel caps had blown off (*See e.g.*, CX 44A). Therefore, it should have been clear to respondent by 1963, and even more so by the early 1970's, just as it became clear to its Product Reliability Group in 1979, that a more complete, more explicit and more direct warning was essential, if further serious accidents of this type were to be avoided.

157. Despite such knowledge, respondent failed to initiate such action until 1980 (*See* Findings No. 167–261, below). Had respondent's record retention policy for accident reports and related data, such as tests, been different, and had the Product [58] Reliability Group had the full benefit of respondent's historical knowledge of the "fuel geysering" problem, it is clear that this Group at least, would have reached the conclusion much earlier, that a better and more direct warning was necessary (Findings No. 155–156).

E. *1972–1979*

158. As noted in Finding No. 119, the Product Reliability Group was founded in 1972. This group centralized the record keeping for product reliability information, including the safety performance of older products in the field. However, in general, it was only able to collect records of such information back to 1969. (Findings No. 119–120).

159. Starting in December 1975 IH inserted in all operator's manuals a National Safety Council Rural Accident Prevention Bulletin concerning safe tractor operation (CX 204A-B, O-P). It continued to

insert this Bulletin in its operator's manuals until December 1978. This bulletin catalogued the common types of tractor accidents as follows: tractor overturn, falling from the tractor, collision with motor vehicles or roadside obstacles, being caught in the PTO (Power Take-Off) shaft, slipping while mounting of dismounting, running over a bystander, striking overhead wires and other obstructions, being struck by broken tractor parts, being fallen on by a poorly supported tractor during repairs, being burned by a fire resulting from an accident or during refueling, being overcome by exhaust fumes in a closed building, and being injured or burned during repair or maintenance operations. (CX 204–O). The bulletin set forth safe operating practices to avoid these tractor accidents, including a reminder to "[f]uel only when engine is off—don't smoke while doing it." (CX 204P).

160. In 1976 IH released a 16 millimeter color film entitled "For Whom the Siren Sounds" (RX 41; Bennett, Tr. 3269). One of a series of seven safety films produced by IH in recent years, "For Whom the Siren Sounds" portrayed many safety hazards involved in operating agricultural tractors (RX 41; Bennett, Tr. 3268–69). Among other things, the film cautioned against the risks of the tractor rolling or tipping over due to operating on steep inclines, of the tractor rearing up backwards due to improper methods of extricating it from a muddy field, of accidents due to extra riders (especially children) on the tractor, of highway collisions due to failure to equip the tractor with a slow-moving vehicle emblem, of dismemberment of hands and arms due to unclogging harvesting and cultivating equipment without first turning off the PTO power, of crushed fingers due to improper procedures for mounting [59] implements, of being crushed by falling bales of hay due to operating the tractor with the front-end loader in an elevated position, of being crushed while inspecting the hydraulic system due to failure to properly prop up hydraulically-powered implements, of the tractor running away due to failure to remove the ignition key and lock the brakes together, of the operator being pulled into moving machinery by loose clothing threads, of falling off the tractor due to slippery steps leading to the operator's compartment, and of a wide range of accidents due to operator fatigue or inattention (RX 41). "For Whom the Siren Sounds" also cautioned against removing the fuel cap while the tractor was running or hot (RX 41). The film was intended to create awareness of the host of dangers associated with farm tractor operation and won an international award for excellence at the Brussels Film Festival (Bennett, Tr. 3269–70).

161. "For Whom the Siren Sounds" has been made available to IH dealers in cartridge form so that it can be shown in the dealership setting (Bennett, Tr. 3268). The film is also distributed through the Grange Foundation, which loans agriculturally-oriented films free-of-

charge to farm organizations (Bennett, Tr. 3268–69). In addition, IH's photo studio sells "For Whom the Siren Sounds" and the other IH safety films to schools for use in Vo-Ag classes and 4–H clubs (Bennett, Tr. 3269).

162. In 1975 or 1976 IH developed a wall poster (27–3/4" × 18–3/4") setting forth rules that operators were urged to follow to avoid tractor accidents (CX 204D; CX 204Z36; Bennett, Tr. 3271–72). The poster warned, *inter alia*, "[d]on't refuel or remove fuel tank cap when engine is running, hot, or when near an open flame" and "[d]on't smoke around fuel" (CX 204Z36). The poster was produced in pad form (each pad consisting of approximately 50 posters) and distributed to all IH agricultural equipment dealers (Bennett, Tr. 3272). The dealers were instructed to post the pad in their dealerships so that farmers could tear off posters to take home and display them where their employees would see them (CX 204D; Bennett, Tr. 3272). The poster was promoted in *IH Farm* magazine and distributed to Vo-Ag classes, Future Farmers of America clubs, 4–H clubs and safety engineers at the University of California (CX 204D).

163. However commendable these latter efforts (Findings No. 159–162) may have been, they still fell short of a direct warning about the safety hazard of "fuel geysering" and they still were not directly communicated to the operators of IH's gasoline-powered tractors (Findings No. 159–162). **[60]**

164. In 1976 IH developed a new decal for application on its gasoline-powered tractors (CX 204D; CX 204Z34; Bennett, Tr. 3152). Since 1947 IH had placed decals on all its production tractors urging operators to read their operator's manuals for safety-related information and instructions (CX 204C-D; CX 204Z23, CX 204Z25; CX 204Z28; CX 204Z31; CX 430; Sullivan, Tr. 5161–63; Kangas, Tr. 548; Clowes, Tr. 1866; RX 184). During a review of IH's decals in 1976, Bennett decided to add a decal to remind operators not to remove the fuel cap from a hot or running tractor (Bennett, Tr. 3152, 3304–05; Zitko, Tr. 1947). While the 1976 decal does not use the specific term fuel "geysering," it was intended to cover the sudden eruption of fuel now known as "geysering" (Zitko, Tr. 1952). Operators who adhered to the decal's warning—to tighten the cap securely and not remove it while the engine was running or hot—would be protected against varying degrees of fuel coming out of the tank (Zitko, Tr. 1952–53). The 1976 decal was installed by IH near the fuel tank filler neck on all new gasoline-powered tractors being built (Bennett, Tr. 3153; CX 204D). However, only 980 of the tractors in issue were produced after 1975 (RX 212). In addition, the decal was included in the service package of decals that IH provided for dealers and farmers to apply on older tractors, such as those that were repainted (Bennett, Tr. 3153–54).

165. The new decal (CX 204D; CX 204Z34) would have been the most effective IH warning up to that time, *had it been adequately disseminated*. Under a caution insignia and the word "CAUTION" in large capital letters, it stated

> AVOID FIRES. TIGHTEN cap securely. Do not open when engine is RUNNING or HOT. (CX 204Z34)

It did communicate the fact that a hazard existed and the principal steps an operator should take to avoid it.

166. In 1976, IH's operator's manuals were revised again (RX 26–114 through 124; RX 26–199 through 212). The earlier warning language against cap removal (*see* Finding 148) was further emphasized by the caution symbol—an exclamation mark inside a triangle—recommended for certain hazard warnings by the American Society of Agricultural Engineers in 1975 (RX 26–209; RX 26–118; RX 250E). The manual stated that the exclamation mark triangle was being used "to call your attention to instructions concerning your personal safety" and that operators should "[b]e sure to observe and follow these instructions" (RX 26–116; RX 26–200). The word "CAUTION!" was added in accordance with the ASAE standards, and the warning was printed in bold-faced type (RX 26–209; RX 26–118; RX 250E). The operator's manual warning included a statement of the precautions the operator should take to avoid fuel geysering, among other things (Lirtzman, Tr. 4662, 4664). The revised [61] operator's manual, like the 1976 decal, contained an express caution to "[b]e sure that the filler cap is tightened securely before starting the engine" (RX 26–209; Zitko, Tr. 1962–63). Again, however, the revised manuals did not specify the hazard involved in cap removal and only applied to later production. Old operator's manuals were not revised and distributed. (Finding No. 148).

F. *1979 to Present: IH's Fuel Fire Prevention Program*

167. Following the Bennett-Arp exchange of March-April 1979 referred to in Finding No. 131, above, the Product Integrity Group, along with IH Engineering, began to put together a program which became known as IH's Fuel Fire Prevention Program.

168. On April 5, 1979, Bennett, elaborating on his March 30 note, wrote a further note to Arp, in which he stated that he was thinking in terms of a major national program that focused on three general areas: good safety practices, tractor/engine maintenance, and gasoline characteristics. In connection with gasoline characteristics Bennett stated that there appeared to be good reason to think that more light ends were being blended into gasoline, that gasohol might in-

volve new hazards, and that a rewrite of the 1968 Service Bulletin on gasoline properties might be appropriate. Bennett noted that gasoline-powered tractors were out of production but that quite a few of them were in use. (CX 118).

169. On April 9, 1979, Arp, responding to Bennett's April 5 note, instructed Bennett to develop an overall plan that covered all bases. Arp requested that Bennett consult with certain IH departments and also with the National Safety Council. (CX 118).

170. On April 27, 1979, following a meeting, Bennett memorialized the "PROGRAM FORMAT IDEAS" as of that meeting (CX 203L; Allen, Tr. 3687–88). The major elements were a direct mailing to customers, a dealer letter, a dealer parts counter display, a maintenance check list for dealers, and a follow-up summer maintenance advertising campaign (CX 203L).

171. In April-early May 1979, IH Engineering set as its objective a solution which would minimize the possibility of liquid fuel escaping from the filler neck (RX 97B). It discussed several methods of attack, including increased warnings, installation of additional heat shields or insulation around the fuel tanks, modifications of the filler neck, and a new fuel cap (RX 97B; Sullivan, Tr. 5124; Hillstrom, Tr. 3455). IH Engineering agreed that the solution should include a renewal of IH's warnings about fuel safety (RX 97B). Beyond that, IH [62] Engineering, after evaluating the pros and cons of alternatives, "generally agreed that the most fruitful investigation would concentrate on a new fuel cap. A new fuel cap that would fit existing tanks would not require tractors to be transported into dealerships to have work performed." (RX 97D).

172. IH Engineering began by reviewing cap designs that were in 1979 state-of-the-art in the automotive field. It determined, however, that the (red) triple baffle cap worked better on tractors than state-of-the-art automotive caps. The automotive caps, while they worked well in the laboratory and on the test track, did not function when the tractor was operated on the torture track. IH, therefore, began to see what could be done to improve the triple baffle cap (Sullivan, Tr. 5124–28; RX 97E-F). It set a target date for the Fall of 1979 (Hillstrom, Tr. 3548).

173. IH Engineering established that: "The prime objective of the new cap was to prevent liquid fuel from gushing onto the operator upon cap removal. In addition, it should have a warning on its top surface. It should minimize any leakage or spillage in the event of an overturn. It should not spurt or spew liquid gasoline to an unacceptable degree during operation. It should prevent rainwater and dirt from entering the tank. It should fit all gasoline farm tractors which use either the 23995–DC flat cap or the 361 909 R91 triple baffle cap,

from the "M" tractor first manufactured in 1939 through the 686 tractor produced until 1978. The new cap should free-vent in the vacuum mode. The new cap should, insofar as practical, vent pressure in the gasoline tank. It should be removed in two stages. Such removal would provide an intermediate venting stage similar to that of a radiator cap." (RX 97D-E).

174. On May 9, 1979, Bennett informed Arp by note that IH Engineering advised that it might be able to improve on the (red) triple baffle cap, though cautioning that many technical problems were involved (RX 199; Bennett, Tr. 3159). Bennett expressed his hope that IH might be able to run a cap exchange promotion in the Fall, in which the farmer was advised in an information bulletin on gasoline safety about the availability of a new cap, and obtain his new cap from IH by filling in and returning to IH a postcard which could be cut out of the information bulletin (RX 199; Bennett, Tr. 3160; Allen, Tr. 3730). Arp, responding to Bennett's May 9 note, wrote: "Good—keep me advised" (RX 199; Bennett, Tr. 3159).

175. On May 18, 1979, there was a meeting at the Product Support Center, the location of the Product Integrity Group, to establish the parameters for a program that combined an educational program on gasoline fire hazards, tractor maintenance, and distribution of an improved gas cap (CX 121A). [63] At the meeting, the participants discussed the preparation of a fold-out mailer for direct mail to customers, as recommended by Bennett in his May 9 note (CX 121A; Bennett, Tr. 3159–60). The contemplation was that the mailer would be a three-fold 8 1/2 × 5 1/2 inch brochure in red colors including a message on gasoline safety, a general safety message, a tractor maintenance check list, and a return postcard (CX 123). The participants discussed the need to determine which of several possible direct mail lists to use, and the need to supplement direct mail with media advertising, displays in dealerships, stories in IH mailers such as Farm Forum, The Winter Overhaul Campaign, a Service Bulletin, and a general news release (CX 121A). They recognized a need to coordinate with the National Safety Council (CX 121B). Further, they considered the preparation of a dealer service check list and a customer safety check list concerning gasoline handling and use. They outlined for further exploration the various considerations involved in mailing out new caps to customers. (CX 121B). They recognized that IH Engineering had to evaluate new cap proposals and that they were to evaluate new warning labels (CX 121B). All basic elements discussed at the May 18, 1979 meeting were ultimately implemented in IH's Fuel Fire Prevention Program (FFPP) (Bennett, Tr. 3161).

176. By May 30, 1979, IH North American Operations had been advised of the overall program and was in agreement to proceed with

it (CX 125B; Bennett, Tr. 3164). As of that date, IH was hoping to promote a new cap by the Fall of 1979 (Bennett, Tr. 3164), and in connection with the new cap IH was continuing to proceed along the lines outlined at the meeting on May 18 (CX 125A). IH was also actively investigating engaging an outside firm to distribute and ship new caps (Allen, Tr. 3690).

177. The projected cap completion date of Fall 1979 was an ambitious one. The normal cycle from innovation to product release in the farm tractor industry is five years (Hillstrom, Tr. 3472–73). If the new product is a component the time can be cut down somewhat, but it is still a long period (Hillstrom, Tr. 3473). The reason for the short goal with respect to the new cap was IH's desire to release it as soon as possible, and its belief that it could utilize proven automotive components from outside suppliers and combine them with the existing tooling and configuration of the (red) triple baffle cap. Unfortunately, the combination was not satisfactory for tractor use. (Hillstrom, Tr. 3473–78).

178. During the Summer of 1979, it became obvious that the development of a new cap was "a complex, involved, difficult thing to do," that a new cap would not be available for distribution in the Fall of 1979, and therefore that IH could not then go forward with a program that touched all bases as **[64]** envisioned in the Spring of 1979 (Bennett, Tr. 3165; *see Hillstrom,* Tr. 3548).

179. As of August 13, 1979, knowing that the August 15, 1979 date for program release could not be met, IH had two choices: it could eliminate the gas cap exchange element and proceed with the information brochure alone in the Fall of 1979 or it could retarget the entire program for the Spring of 1980. Bennett recommended retargeting on the grounds that Fall was a low risk season for fuel fires and that the advantage of including a new cap offer in the brochure to focus attention on safety information in the brochure outweighed the disadvantage of a few months delay. (CX 133).[21] Bennett recognized, however, that a new cap, though retargeted for Spring 1980 (Hillstrom, Tr. 3548), might not be available by Spring of 1980. He recommended in strong terms that IH proceed with distribution of the brochure in the Spring of 1980 regardless of whether a new cap was available (CX 133).

180. Beginning November 1, 1979 and continuing for six months, there was a strike at IH (Bennett, Tr. 3166). The strike slowed down the engineering development of a new cap and precluded in that period the manufacture of a new cap by IH (Bennett, Tr. 3166).

181. As of November 15, 1979, IH showed a budget accrual of $2,850,000 for the field campaign expense for the FFPP (RX 200). As

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[21] There is no evidence of record of any fuel fires occurring during the Fall of 1979 (CX 220).

a result of the budget accrual, $2,850,000 had been set aside for the FFPP and could not be expended for any other corporate purpose. (Bennett, Tr. 3167).

182. During November of 1979, it became apparent that a new cap would not be ready by Spring 1980. As a result, Bennett decided that the program should be split in two parts, with the safety promotion part of the program being targeted for the Spring of 1980 and with the cap exchange portion deferred until the new cap became available. (Bennett, Tr. 3168).

183. On November 9, 1979, Bennett sent a memorandum to Arp recommending that IH "proceed with a campaign to provide information and instruction regarding gasoline volatility and safety precaution to the agricultural community." Bennett noted that the new cap under development looked promising but advised Arp that reference to it in a field campaign was premature at that time. Bennett observed that IH was "at the point where the information bulletin, posters, and decals must be committed in [65] order to have them in customer and dealer hands in time for Spring field work." (CX 141).

184. IH, acting on Bennett's November 29 recommendation, went forward with the promotional part of the program in the Spring of 1980 (Bennett, Tr. 3169).

185. Pursuant to the decision to proceed with the promotional part of the program, IH prepared for distribution and in the early Spring 1980 distributed (1) NEW FACTS ABOUT FUELS (CX 153); (2) the 1980 Warning Decal (CX 152); (3) a countercard entitled "HOW SAFE ARE YOU?" (RX 55); (4) a letter dated March 3, 1980 from Arp to all AE [Agricultural Equipment] Regions entitled "Facts About Fuels Program" (RX 56A); (5) a Recommended Dealer Announcement Letter entitled "Facts About Fuels Program" (RX 56B); (6) Service Bulletin No. S-3981 dated March 7, 1980 (RX 202A-B); (7) Service Bulletin No. S-3982 dated March 7, 1980 (RX 57A-B); and (8) letter dated March 24, 1980 to AGRICULTURAL SAFETY LEADERS (CX 154). However, this part of respondent's program did not include a direct mailing to IH's customers, media advertising, nor general news releases (*See* Finding No. 175).

186. "New Facts About Fuels" (CX 153) is a fold-out brochure. The back cover states in large print:

> Did you know GASOLINE has become more EXPLOSIVE recently? Gasohol is even more so.

When the brochure is initially unfolded, information concerning fuel volatility and handling is given under three topic headings: "Here's what's happened to gasoline. . .;" "And what about gasohol?;" and

"There's even more need to be careful!" When the brochure is fully unfolded, the two center pages, with supporting illustrations and text, emphasize the need to work safely with fuel, the importance of a careful operator, a short safety check list for the operator, and an exhortation to attach IH's 1980 Warning Decal (discusssed below in Finding No. 188), along with a full size reproduction of the decal.

187. Under the heading "Here's what's happened to gasoline . . ." in CX 153, the brochure discusses increases in fuel volatility over the years and states:

> The higher volatility of gasoline being marketed today makes it more explosive and, consequently, more dangerous to use. The more rapid vaporization causes tank [66] pressures to go up. If the cap is quickly taken off a tank when it is hot, explosive vapor or fuel may escape. Any chance spark, lit cigarette, or open flame could ignite it, causing an immediate explosion or fire with the possibility of serious injury to anyone in the area.

Under a heading "Working safely with today's fuel," the brochure cautioned among other things: "Always tighten the cap securely;" "Never take the cap off or refuel when the engine is running or hot;" "Don't fill your tank to capacity . . . allow room for expansion;" "Schedule your gasoline purchasing so that you won't hold 'winter gas' over to Spring;" and "Make sure everyone operating your equipment follows all the safety rules in the operator's manual. If you don't have an operator's manual, contact your local dealer or International Harvester." Under the safety check list for the operator, the brochure advises the operator, among other things, to: check the exhaust system for broken manifolds, loose exhaust pipes, broken mufflers and leaking gaskets; make sure the fuel tank heat shields are in place; and only use the correct fuel cap, making sure it's in good condition. (CX 153).

188. The 1980 Warning Decal (CX 152) which was distributed at this time was larger and more explicit than that put out in 1976 (Findings No. 164, 165). It, and the full reproduction of it in CX 153, had a large ASAE caution insignia and the word WARNING in large print, on a yellow background, for a heading. It then stated:

> A FUEL FIRE CAN BURN YOU.
>
> Tighten cap securely. Do not open if engine is running or hot, near flame, sparks, or while smoking. Explosive vapors or fuel may escape. Shut off engine and let it cool before opening cap.

189. The "How Safe Are You" Countercard (RX 55), distributed at this time, was a cardboard poster designed for display in dealerships (Bennett, Tr. 3180). In addition to the title, the countercard had addi-

tional captions, "Do today's gasolines require more care?" "What about gasohol?" and "How can you work safely?" At the bottom, pockets held copies of "NEW FACTS ABOUT FUELS" (CX 153) and the 1980 Warning Decal (CX 152), with "FREE Take One Of Each" printed across the pockets (RX 55). The purpose of the countercard (RX 55) was to [67] attract the attention of farmers to the brochure (CX 153) and decal (CX 152). As Bennett explained: "Getting farmers to pick up these brochures and decals and use them" (Bennett, Tr. 3180).

190. These materials (RX 55; CX 152; CX 153) were distributed in the Spring of 1980 through respondent's dealer network. The dealers were asked not only to prominently display the furnished materials, but also to "hand out brochures and labels when calling on customers and prospective customers, affix labels to all used gasoline engine equipment in inventory and on all such customer machines coming through your service department, promote distribution of this material through local groups such as: 4H, FFA, Vo-Ag classes, etc., and generally promote safe fuel handling practices to the fullest extent." (RX 56B).

191. In Service Bulletin No. S-3981, dated March 7, 1980, which IH distributed through its field service organization to all agricultural equipment dealers, IH advised that "One of the causes of fuel fires on equipment is careless and improper maintenance." IH suggested certain routine checks, including the exhaust system (for broken manifolds, loose exhaust pipes, broken mufflers, and leaking gaskets), heat shields and insulation if required to make sure they were in place, and the fuel cap to be sure it was the correct one and in good condition. (RX 202A-B).

192. The information in Service Bulletin No. S-3981 (RX 202A-B) was the same information as that in NEWS FACTS ABOUT FUELS (CX 153), but IH "wanted to put it into a service bulletin so that it would go into the dealer service bulletin for his book that he keeps there so he would always have it" (Bennett, Tr. 3186). The underlying reason was that IH was of the opinion that improper maintenance was a very important factor in tractor fires because IH investigation of specific accidents had shown improper maintenance to be a major contributing cause (Bennett, Tr. 3186-87, 3211; Allen, 3690-91).

193. In Service Bulletin No. S-3982, dated March 7, 1980, which IH distributed through its field service organization to all agricultural equipment dealers, IH reminded dealers of the policy of updating and replacing safety labels on agricultural equipment, specifically advised dealers of the availability of the 1980 Warning Decal (CX 152), and stated that this decal "should be applied near the fuel cap of all

gasoline-powered machines going through your shop and on your lot." (RX 57A-B; Bennett, Tr. 3185; Allen, Tr. 3703).

194. In the March 24, 1980 letter to AGRICULTURAL SAFETY LEADERS, IH advised that: "Fires can result in estremely serious injuries. Agricultural equipment is particularly [68] vulnerable to fire because of the wide variety of operating environments, long working life, extensive use of hydraulics, frequent lack of proper maintenance, wide range of operator skills, etc. Fuel fires are of particular concern because of the large volume of fuel carried on board and its proximity to the operator. In addition, the changing characteristics of fuels being marketed and the availability of a variety of fuel system modification kits which alter operational factors in ways not contemplated in original design can create serious fire hazards." IH offered to supply at no cost reasonable quantities of NEW FACTS ABOUT FUELS (CX 153) and the 1980 warning decal (CX 152) and enclosed copies for reference. IH urged that leaders stress safe use of farm fuels in these programs. (CX 154; Bennett, Tr. 3189-90).

195. The Agricultural Safety Leaders, who received the March 24, 1980 letter, along with the NEW FACTS ABOUT FUELS (CX 153) and 1980 Warning Decal (CX 152), were the membership of the National Institute of Farm Safety (which includes state farm safety specialists, University specialists, United States Department of Agriculture safety specialists), high school teachers teaching agriculture, Future Farmers of America clubs, and insurance people (Bennett, Tr. 3187). (For IH's actual mailing list, *see* CX 155A-U).

196. IH received many requests for NEW FACTS ABOUT FUELS (CX 153) and the 1980 Warning Decal (CX 152) from agricultural leaders (RX 271A-C). IH received many favorable comments about these materials, including one from Rollie Schneider of Nebraska, a farm safety specialist and from Bill Cox, a specialist with the United States Department of Agriculture (Bennett, Tr. 3188-89).

197. Although the materials disseminated in the Spring of 1980 did not mention "fuel geysering" by that term, that hazard is clearly covered by the wording of these materials and the precautions urged meet all of the steps indicated by this record which were required to prevent fuel geysers. They warned the operator of the danger posed by pressure in the fuel tank, instructed him to properly secure the fuel cap and never remove it while the tractor was running or hot, and told him to keep his tractor and fuel tank properly maintained (Lirtzman, Tr. 4672-73, 4682-83, 4699-4700: Swanson, Tr. 4806-10). Complaint counsel have implicitly conceded that these warnings are sufficient, by their endorsement of the later August 1980 letter as being effectively written, although it urges no further precautions (CX 375; *Transcript of Prehearing Conference* of December 16, 1980,

p. 9), and by their concession that a properly secured fuel cap cannot be "blown off" (*See* Finding No. 32, above). The only question remaining then is whether these materials were adequately disseminated. [69]

198. There is some question in my mind about the adequacy of the dissemination of RX 55; CX 152; CX 153 and RX 202A-B, in the Spring of 1980. That dissemination still relied primarily on the dealer network and did not yet incorporate an attempt to directly contact the operators of IH tractors. At the same time, the materials being used were more explicit than past materials and were of a type less subject to dealer discretion. It was also coordinated with a program operating through agricultural leaders. This provided a synergistic effect which could be expected to enhance the effectiveness of the materials (Lirtzman, Tr. 4625–26, 4632–34, 4643–45, 4706–07, 4740–42). However, it is not necessary to decide whether this was sufficient without a direct approach to operators, because a direct approach was soon made (Findings No. 199–205, and 224–238, *infra*).

199. As previously noted (Findings No. 170, 175) Bennett had planned in April/May 1979 on a direct mailing to operators which would be coupled to the gas cap exchange when the new fuel cap was ready. In January 1980, an initial draft of such direct mailing was prepared, but shelved since the new fuel cap was not yet ready for distribution (CX 216C–E). Over succeeding months, the new black gas cap progressed toward readiness for distribution. In a memo of May 30, 1980, it was finally noted that 200 sample caps would be available shortly after July 14, 1980 (RX 61). In a July 10, 1980 program proposal, which set forth the "Gas Cap Program Elements," Bennett listed as one of the items under "Program Promotions," a "Direct Mail Layout and Text" (RX 65A). On July 21, 1980, instruction was given to prepare the text of the direct mail piece (CX 216A). The initial outline was prepared on August 3, 1980, and an expanded version was ready by August 5 (CX 216A; CX 216F; CX 216Z2–3). The final version of the letter, mailed on August 14, 1980, adhered in substantial measure to the August 3 and August 5 outlines (CX 216F; CX 216Z2–50; CX 375). Consistent with Mr. Bennett's planning back in May 1979, the purpose of the direct mail piece was not only to warn IH tractor operators, but also to promote the free distribution of the new black cap (CX 375).

200. Complaint counsel concede that the warning of the August 1980 letter is adequate to prevent further fuel geysering accidents, if the precautions therein are adhered to. They only argue that the dissemination thereof was insufficient (*Transcript of Prehearing Conference* of December 16, 1980, p. 9).[22] [70]

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[22] They also argue that the August 1980 letter was not a voluntary undertaking of respondent, but that it was

(footnote cont'd)

201. The August 1980 warning letter had a large, bold-type heading which stated:

> IMPORTANT SAFETY WARNING AND ANNOUNCEMENT OF NEW, FREE REPLACEMENT GASOLINE CAP FOR OWNERS OF INTERNATIONAL HARVESTER GASOLINE POWERED FARM TRACTORS

Under the heading:

> DANGER—Fire and personal injury.

It stated that "If the fuel cap is removed when the gasoline tank is hot and vapor pressure has, under certain circumstances, built up in the tank, this sudden release of pressure could force gasoline out of the tank. If the gas cap is not fully secured and tightened, it could come off the tank, and again, gasoline could escape. This sudden eruption of gasoline exposes the operator to, and may cover him with, liquid fuel and vapors and is a clear fire hazard if a source of ignition is present. . . ." (CX 375)

202. Under the heading "PRECAUTIONS—Observe operator's manual warnings and common sense safety rules" the August 1980 letter further tells the operator:

> *Always tighten gasoline caps securely. Never, under any circumstances, take the gas cap off a hot or running tractor.* (Emphasis in original). (CX 375)

This same heading urges the operator to "Maintain your equipment properly and pay particular attention to its electrical, exhaust, fuel and cooling systems. . . ." (CX 375). It then warns that:

> *Fires involving serious injury and even death have happened when these precautions were not followed.* (Emphasis in original). (CX 375)

203. The August 1980 letter also informs the operator that a new gas cap "designed to inhibit the sudden eruption of liquid fuel if the safety prrecautions against cap removal are not observed" was being tested and would be distributed soon. The letter then gives instructions on how the fuel cap would be obtained and repeats the warning:

> When you do operate your gasoline-powered farm tractor before you get your new cap, [71] be sure to follow all safety precautions mentioned above. Be alert to any unusual sights and sounds during operation; if you suspect overheating or pressure build-up in

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prepared and distributed under pressure of the Commission's investigation (CRB 26-28). The evidence cited by complaint counsel is speculative and does not adequately substantiate this claim, as is discussed below in Findings No. 301-308.

> the fuel system, do not touch the cap. Turn off the engine and allow the tractor to cool before you touch the cap. (CX 375)

The letter then encourages operators to obtain the "New Facts About Fuels" brochure and a free "Warning" decal from their International Harvester Dealer and to pass on all of this information to other people they know who operate International Harvester gasoline-powered tractors (CX 375).

204. There was no list of present owners of IH gasoline-powered tractors (Allen, Tr. 3725). For a direct mailing, the possible alternatives considered by respondent were: IH's customer mailing list, a list of Rural Route boxholders, and the Farm Journal mailing list (CX 121A).

205. CX 375 was sent to the 630,000 operators on respondent's customer mailing list. This list is updated constantly and is used by IH for mailings to customers and potential customers (Colwell, Tr. 3614). This mailing list is based on information supplied by the dealers, and the names and addresses are grouped by dealership (Bennett, Tr. 3206–07, 3226; Allen, Tr. 3707–08). IH had decided that the most effective gas cap exchange was one arranged through its dealer network. Since the letter also notified the operators of the impending availability of the new safety gas cap and how to go about obtaining one, this was an important factor in the selection of its own customer mailing list as the vehicle for mailing the warning letter. As a result, respondent was not required to ascertain the name of the appropriate dealership in the event the farmer neglected to advise it of his dealership in the same manner that IH carries the name of the dealership on its records. (Bennett, Tr. 3207–08). This was a significant advantage (Bennett, Tr. 3207–08; Allen, Tr. 3717–18; RX 273B, ¶ 7).

206. There is no reliable evidence of record which indicates that a better mailing list was available to IH for the mailing of its warning letter. Therefore, I find that its own customer mailing list was equal to, or better, for this purpose than any other mailing list that may have been available (Findings No. 204–205, above).

207. The August 1980 warning letter was mailed in a special envelope which was embossed across its face with the wording: [72]

> Important! Safety Information Enclosed (RX 71G; Bennett, Tr. 3205).

IH also enclosed in the envelope a No Postage Necessary Business Reply Mail Card, on which the farmer was to provide the model and serial numbers of each IH gasoline-powered tractor owned by him, for use in connection with the gas cap exchange program (RX 71E-F; Allen, Tr. 3706–07).

208. Following the mailing of the August 1980 warning letter, IH undertook other steps to supplement this mailing in accordance with its prior plans (Finding No. 175; CX 121; CX 125; CX 126; CX 127).

209. On August 14, 1980, IH sent a letter to each dealer entitled, "SAFETY WARNING AND NEW FUEL CAP PROGRAM TO MINIMIZE RISK OF PERSONAL INJURY IN GASOLINE TRACTOR FUEL FIRES." (Bennett, Tr. 3205; RX 71B-C). The letter advised the dealer that IH was "continuing to alert its gasoline-powered tractor customers to important safety information in connection with the serious hazard of fuel related fires" (RX 71B). IH advised that it would be immediately sending to customers the IH August 1980 letter (CX 375), summarized the purpose of the letter, and enclosed a copy of the letter and the Business Reply Mail card to be sent with it (RX 71B-G). IH advised that "This letter will be followed by advertisements in agricultural trade magazines and counter displays for your dealership to advise tractor owners of the availability of the new cap, to alert them to serious hazards associated with gasoline-powered farm equipment, and to point out the importance of good tractor maintenance." IH advised the dealer that the paramount goal was the protection of the farmer, that the dealer must read the letter carefully, and if he sold a used tractor subject to the program before the black cap was available for distribution, he was to provide the farmer with the information in the Warning Letter, specifically advise him of the new cap, and give him a card so that he could obtain a new cap. (RX 71B). IH stated: "Be sure that you send in cards for every applicable gasoline tractor on your lot and any you know anywhere in your trade area!" IH furnished each dealer the same cards (RX 71E-F; also RX 72, p. 16) enclosed with the IH August 1980 Warning Letter (CX 375) to be filled in and returned by the dealer for all gasoline-powered tractors on his lot. (Allen, Tr. 3707).

210. In September 1980, IH sent a letter to agricultural leaders stating the major points focused upon by the IH program, requesting their assistance, promising quantities of information [73] and warning materials at no cost, and enclosing the IH August 1980 Warning Letter and NEW FACTS ABOUT FUELS (CX 248).[23] (RX 218; Bennett, Tr. 3208; Allen, Tr. 3709; RX 72, p. 19). IH sent the letter to all persons on IH's mailing list of agricultural leaders (CX 155), as well as many others (Bennett, Tr. 3209; Colwell, Tr. 3614). The purpose of sending the letter to agricultural leaders was "to put it in the hands

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[23] This was a new or second version of the NEW FACTS ABOUT FUELS brochure (*Compare* CX 248 with CX 153). It had been revised to distinguish between gasohol made from ethyl alcohol and that made from methyl alcohol, as a result of criticism received from the gasohol industry. I find that the criticisms underlying this change and the changes in wording which resulted are not relevant to the central charges of the Complaint herein (Bennett, Tr. 3170-71; 3190-91, 3194; Allen, Tr. 3696-97).

of what we call opinion leaders. People who have strong influence on farm safety throughout the country." (Colwell, Tr. 3614).

211. IH prepared for delivery to each dealer a printed INSTRUCTION MANUAL (RX 72; RX 203D). This manual entitled "Gasoline Powered - Agricultural Tractor" and subtitled, "Fuel Fire Prevention Program" described for the dealer IH's FFPP (RX 72; Allen, Tr. 3700). The intent was to give the dealer all the information he needed in order to administer his end of the program (Bennett, Tr. 3210; Allen, Tr. 3700). It was 32 pages in length, and, in addition to text specially prepared for the manual, contained a reprint of the materials that IH developed in connection with the Program. It especially discussed features of the black cap, identified the tractor models covered by the cap exchange, and provided the details involved in the actual cap exchange. (Allen, Tr. 3701 and 3710–11; RX 72). The INSTRUCTION MANUAL was bound in thick, glossy paper, and was perforated for storage in a three-ring binder (RX 72).

212. IH prepared an "Outline for District Personnel" to be used as a talking paper by IH district personnel to guide them in explaining the IH program to dealers when they personally called on each dealer for the purpose of explaining the IH program and delivering the Fall kit and INSTRUCTION MANUAL (Bennett, Tr. 3212–13; RX 203A-E). The outline began: "IH is contacting its Dealers to discuss an important problem—the threat of serious injuries from gasoline fuel fires on tractors with the traditional gasoline tank location in front of the operator. The phenomenon that creates the threat is the excessive build-up of heat in gasoline tanks, which build-up causes high vapor pressure. If an operator fails to tighten the gasoline cap securely or improperly removes it while the engine is running or hot, gasoline and vapors could, under certain [74] circumstances, erupt from the tank, covering the operator with fuel." The outline then reviewed the entire IH FFPP, with emphasis on the importance and scope of the dealer's participation. The outline stressed that the FFPP had the complete support of IH management and "was not forced [on IH] by the government." (RX 205D). The outline emphasized the need to review the Fall kit and the INSTRUCTION MANUAL with each dealer. (RX 203–O).

213. IH conducted one meeting in each of its six regions, with regional managers and as many district managers as possible in attendance, to explain the IH program and to instruct them on how to administer the program in their areas (Bennett, Tr. 3215, 3231–32; Allen, Tr. 3719–20, 3735). A presentation, based on the "Outline for District Personnel" (RX 203A-E), was made at each dealership (Bennett, Tr. 3213–14). IH District personnel visited each dealership in September/October 1980, at which time the INSTRUCTION MANU-

AL and Fall kit were delivered, the manual was reviewed, and the kit was assembled (Bennett, Tr. 3210–11, 3215–17; Allen, Tr. 3720–21, 3741–42).

214. The Fall 1980 kit (RX 75), which was assembled at each dealership, consisted of the "FREE GAS CAP and important safety warning about your gasoline powered IH tractor" countercard, and quantities of the second NEW FACTS ABOUT FUELS brochure (CX 248), the 1980 Warning Decal (CX 152), and a No Postage Necessary Business Reply Mail Card (entitled "FREE GASOLINE CAP OFFER"), which was to be filled in by owner and dealer for mailing to IH to obtain the black cap (*See* Allen, Tr. 3708), and which on a detachable portion contained in reduced print a reprint of the IH August 1980 Warning Letter. The brochure, decal, and "FREE GASOLINE CAP OFFER" card fitted in holding racks supported by the countercard, upon assembly. The countercard itself showed a picture of an IH tractor, a cut-out picture of the black cap, and written exhortations to take and read the materials in the racks. (RX 75; Bennett, Tr. 3216).

215. On September 18, 1981, IH sent a parts service marketing letter to all dealers announcing a "TRACTOR TUNE-UP CAMPAIGN" (RX 74A-B). It stressed the importance of proper maintenance because, among other things, "it prevents injuries" (RX 74A). It stated that the tune-up campaign was an integral part of IH's FFPP. It promised that the dealer would "receive promotional materials at no-charge to support a hard-hitting, visible, and successful tune-up campaign." These materials will consist of "Window Banner[,] Counter Easel Card[,] Local Co-op Advertising Materials." (RX 74A; Bennett, Tr. 3218). IH attached to the letter, a list of parts commonly used in a tune-up, including a list of Heat Shields, and Assemblies, and a Gasoline-Powered Tractor Check List (RX 74C-G). The intent was [75] to solicit tune-ups from farm customers who owned gasoline-powered tractors (Allen, Tr. 3703–04).

216. Pursuant to the promise in Finding No. 215, IH distributed a Window Banner (Bennett, Tr. 3236), a "Your tractor works better when it's in tune" countercard, which also stressed "reduce fire hazards" (RX 221), and two ad slicks stressing maintenance (RX 72, pp. 14–15), in which IH paid half the dealer's cost (Allen, Tr. 3705–06; Bennett, Tr. 3230).

217. IH, in response to dealer suggestions, also developed and distributed in two versions a detailed "Gasoline Powered Tractor Check List," one version for dealers and one for farmers (Allen, Tr. 3705; RX 75, pp. 12–13). The farmer received his check list in the same mailing in which he was notified that the black cap was ready to be picked up at his dealership (Allen, Tr. 3705).

218. IH also distributed a wall chart entitled IH TUNE-UP PARTS

to be posted in the dealership (RX 219; Allen, Tr. 3704). Special emphasis was placed on Heat Shields and Assemblies, the black cap, and a Filler Neck Renewal Package (RX 219). Such a wall chart is typically displayed where both the parts man and customer can read it (Bennett, Tr. 3219–20).

219. IH provided ad slicks to all dealers to advertise the cap exchange program in local newspapers (Allen, Tr. 3706; Bennett, Tr. 3220; RX 72, p. 18; RX 79A-B). The advertisement repeated the basic message of the IH 1980 Warning Letter (*E.g.,* RX 79A). IH paid half the total cost of advertisements run by dealers (Bennett, Tr. 3230).

220. On September 23, 1980, IH issued a news release to call attention to the gas cap exchange program and to reiterate fuel handling safety precautions (Colwell, Tr. 3620; RX 189A-B). The news release went to 200 farm broadcasters, 100 farm trade publications, and a small number of television farm correspondents (Colwell, Tr. 3620). The central message of the news release was run as written, and headlined as a safety gas cap exchange program in newspapers and farm trade publications (Colwell, Tr. 3623; RX 81A-T).

221. Beginning in November 1980 IH ran an extensive media campaign, described in detail in Findings No. 224–238, below.

222. IH ran an advertisement repeating the basic message of the IH 1980 Warning Letter, including free cap exchange offer, in the Fall issue of *IH Farm Forum* (Bennett, Tr. 3226; RX 76). *IH Farm Forum,* published by IH, is distributed to all persons on the IH mailing list (Bennett, Tr. 3226; *see* Findings 205 and 206, *supra*). The purpose was to give IH customers another direct exposure to the IH program (Bennett, Tr. 3226). **[76]**

223. IH made the decision to include the IH August 1980 Warning Letter (CX 375) in all operator manuals for gasoline-powered tractors which were requested of IH, and has since done so (Allen, Tr. 3702; RX 211).

224. Respondent's early plans in 1979 had included provision for media advertising to supplement the direct mailing (CX 121; CX 123; CX 126). This was an important part of respondent's program since a perfect list of all tractor owners was unavailable (Finding No. 204).

225. Sometime after September 9, 1980, the copy and format of IH's media ad were finalized (Southwick, Tr. 4261). The ads were then published in October 1980, November 1980, December 1980 and January 1981 editions of various leading national and regional farm trade magazines (RX 82B-Z-41). Respondent's advertising agency ran a check to make sure the positioning and reproduction of the ads were acceptable. This check revealed that IH's ads had received very good positioning in such publications. (Southwick, Tr. 4264–65).

226. The Fall and Winter ads communicated the nature and conse-

quences of fuel geysering, as well as the steps to be taken to prevent it (fully secure fuel cap, don't remove fuel cap when tractor is hot and running, and keep tractor properly maintained). It also promoted the free gas cap exchange program and included a cut-out coupon to be sent in to IH to obtain the new gas cap. (CX 388A).

227. The advertisement was changed slightly and rerun in the Spring of 1981 (Southwick, Tr. 4268; RX 246H; RX 92A-H). The revision was similarly worded in all important respects and was just as effective in communicating the basic message of a fire hazard and the means for its prevention (*Compare*CX 388B with CX 388A). The main change was the highlighting of a warning to "Use Winter gasoline carefully in the Spring," at the top of the ad (CX 388B).

228. Both the Fall and Spring ads effectively communicated the nature and consequences of "fuel geysering," as well as the cautions concerning it (CX 388A; CX 388B).

229. These ads were also run in respondent's own *Farm Forum* magazine in the Fall of 1980 and the Spring of 1981. This magazine is distributed to the persons on IH's mailing list. (Bennett, Tr. 3226; Colwell, Tr. 3626–27; RX 76).

230. Foote, Cone & Belding Media Supervisor Ruth A. Southwick performed two analyses of the reach and frequency [77] achieved by IH's media campaign (RX 94B; Southwick, Tr. 4270–71). Southwick's first analysis was performed in February 1981 after the initial schedule of ads had run. Her second analysis was performed in May 1981 after the Spring ad had run. (RX 94B; Southwick, Tr. 4270–71).

231. The term "reach" refers to the percentage of the target audience that had an opportunity to be exposed to the advertising message (Southwick, Tr. 4271). Reach is calculated on the basis of circulation data for the publications in which the ad appeared and takes into account duplication of circulation (Southwick, Tr. 4271). The circulation data used by IH's advertising agency is "audited" by an independent board that verifies the number of copies of a given issue actually printed and confirms that the magazines were actually sent out as reported (Southwick, Tr. 4272). In the course of her duties at the agency, Southwick customarily seeks to determine the reach of any given media ad and relies upon reach in making media-planning judgments (Southwick, Tr. 4272).

232. The term "frequency" refers to the average number of times that a member of the target audience has been reached by the advertising message (Southwick, Tr. 4272–73). Like reach, frequency is calculated on the basis of audited circulation data that take into account duplicated or overlapping circulation such as occurs if a given farmer subscribes to more than one magazine in which the ad appeared (Southwick, Tr. 4272–73).

233. The best available data for making reach and frequency determinations is that compiled by Doane Agricultural Service, Inc. (Southwick, Tr. 4274). Doane's data are based upon surveys of Class I through IV farmers (Southwick, Tr. 4274). Neither Doane nor anyone else measures circulation to farmers of income levels lower than Class IV (Southwick, Tr. 4274, 4277). However, the fact that circulation figures are not compiled for Class V-and-under farmers does not mean that farm trade publications do not reach those farmers (Southwick, Tr. 4277–78). Moreover, USDA and Census data indicate that the number of farms in the Class-V-and-under category is decreasing (CX 387K; RX 247K; Southwick, Tr. 4274–75). The number of farmers may be less than the number of farms because one farmer may be operating more than one farm (Southwick, Tr. 4275–76). USDA data also indicate that over 80 percent of the used tractor purchases in 1979 were made by Class I to IV farmers (RX 247C).

234. Southwick's February 1981 analysis of IH's October 1980-January 1981 media campaign was based upon Doane's 1980 Farm Media Measurement Study (RX 94F). Southwick's analysis showed that IH's first ad, which appeared in 5,812,014 magazines, reached 90 percent of the target audience nationwide with an average frequency of 4.46—in other words, 90 percent of the target audience was exposed to the advertising message [78] at least once and the average number of exposures per farmer was approximately 4 1/2 (RX 94B; Southwick, Tr. 4278). In the regions where IH requested "heavied-up" coverage—the Midwest and East,[24]—the reach was 95.8 percent and 94.5 percent, respectively (RX 94F). The average frequency in these regions was 5.28 and 5.20, respectively (RX 94F).

235. Southwick's May 1981 analysis, performed after IH's Spring 1981 ad had run, was also based upon Doane's 1980 Farm Media Measurement Study (RX 94G). Southwick's analysis showed that the spring campaign increased the nationwide reach by two percent—to 92 percent—and the average nationwide frequency from 4.46 to 6.04 (RX 94B). However, in the "heavied-up" regions of the Midwest and East, the reach was not increased from the 95.8 percent and 94.5 percent levels already achieved by the first ad (RX 94G; Southwick, Tr. 4278–79). The average frequency in those regions was increased, however, from 5.28 and 5.20 to 7.04 and 6.94, respectively (RX 94F-G; Southwick, Tr. 4279).

236. Based upon the two analyses she performed and her training and experience, as well as upon her agency's experience, Southwick concluded that IH's media campaign achieved an "extremely high" reach (Southwick, Tr. 4279). She also concluded that the expenditure

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[24] IH had requested heavier coverage in these areas because it had reason to believe the greatest concentration of fuel geysering incidents occurred in these areas (CX 220; Colwell, Tr. 3618).

of more money by IH on additional ads, or on radio or television advertising, would not increase to any significant degree the levels of reach and frequently already achieved (Southwick, Tr. 4279, 4299).

237. In its consideration of possible advertising media for this program, respondent's advertising agency, Foote, Cone & Belding, had considered both radio and television as a means of disseminating IH's safety message (Southwick, Tr. 4253). After analyzing the coverage obtainable by use of television, the advertising agency's media planners decided not to recommend television because the ratings were low for the total number of households and would be even lower if non-farm households were factored out (RX 238A-C; Southwick, Tr. 4255–56). It was their opinion that television was not an appropriate medium given the complexity of IH's message and its purpose to include a response mechanism (Southwick, Tr. 4285). Respondent's own communications experts agreed that print was a better means of [79] reaching farmers than broadcast media such as television (Colwell, Tr. 3619; Dahlman, Tr. 4190–91).

238. In the absence of reliable evidence showing that some other advertisement format, published in some other media, would have been more effective, and in view of my own review of the advertisements which respondent placed in these national and regional farm publications (CX 388A; CX 388B), I must find that respondent's advertising campaign was a well designed program to supplement the direct mailing and other steps taken in IH's Fuel Fire Prevention Program (Findings No. 226–237).

239. In March 1981, IH's regional managers sent a letter to all agricultural equipment dealers in which, among other points, IH urged its dealers: to remind their customers about the volatility of winter-grade fuels and the danger of fire if pressure in the fuel tank is suddenly released, to remind their customers of basic safety precautions concerning cap removal, including tightening the cap securely and never removing it from a hot or running tractor; and to encourage their customers to obtain the black cap. IH again asked dealers to encourage their customers to maintain their equipment (RX 204B-C).

240. IH, in a page in its Spring 1981 Parts & Accessories catalogue, urged farmers to save fuel, increase horsepower, and reduce fire hazards through proper maintenance. IH featured the black cap and urged farmers who had not done so to exchange their old cap for a new one. (RX 220B). The Spring Parts & Accessories catalogue was mailed to all persons on the IH direct mailing list (Bennett, Tr. 3241).

241. IH released public service announcements (20–second, 30–second, and 60–second versions) for television on fuel safety in the Spring of 1981 (RX 106; Bennett, Tr. 3238 and 3241–42). These announce-

ments were distributed to about 100 stations with farm audiences and shown as many as 200 times by a single station (Bennett, Tr. 3242).

242. In the Fall of 1981, IH by letter urged dealers to continue to display in a prominent place the FREE GAS CAP and important safety warning about your gasoline-powered IH tractor" countercard (RX 75) and to make sure that the holders on the countercard were stocked with sufficient supplies of 1980 Warning Decals (CX 152) and NEW FACTS ABOUT FUELS (CX 248). (Colwell, Tr. 3627; Allen, Tr. 3723–24).

243. IH sent a letter to oil companies requesting that they encourage fuel distributors to warn farmers about the increasing volatility of fuel when the suppliers deliver fuel to the farmer (Colwell, Tr. 3627, 3631). **[80]**

244. In November 1981, IH ran again in IH *Farm Forum* the same advertisement used in the Fall of 1980 (Colwell, Tr. 3626–27).

245. As of December 1, 1981, the "FREE GAS CAP and important safety warning about your gasoline-powered IH tractor" countercards (RX 75) remained on the counters of 1800 IH dealers throughout the United States (Colwell, Tr. 3632).

246. As of December 31, 1981, IH had received 138 requests for safety information from 114 non-IH organizations, and had distributed 36,136 NEW FACTS ABOUT FUELS (CX 153, CX 248), 46,000 1980 Warning Decals (CX 152), and 5014 tractor maintenance check lists to non-IH organizations such as 4–H clubs, county extension agents, Vo-Ag classes, Future Farmers of America clubs, etc. (RX 271A and C-F). This was exclusive of IH distribution to IH dealers and customers (RX 271C).

G. *The Black Gas Cap And The Gas Cap Exchange Program*

247. The new black gas cap was a redesign of the (red) triple baffle cap. The base of the cap was changed to eliminate any possibility that an operator could remove the cap with one twist of the wrist. It had an intermediate venting stage, similar to a radiator cap. Thus, at the intermediate point, venting could occur through the bottom of the cap if there was sufficient pressure in the fuel tank, with no danger that the cap would come off in the operator's hand. The holes in the internal baffling were enlarged and a second vent hole was added. This increased the venting capacity of the cap, in order to further reduce pressure in the tank. (Sullivan, Tr. 5125, 5127–28; RX 97F-G). The new black cap does not eliminate pressure build-up in the fuel tank, but merely prevents the operator from completely removing the cap before the pressure is vented (Sullivan, Tr. 5182–84, 5127–28).

248. Beginning in the Fall of 1981, IH began to ship caps to its

dealers, the dealers began exchanging black caps for old caps, and that exchange continues to the present day (Bennett, Tr. 3238).

249. Upon receipt of a request for a cap, IH determined if the request constituted a "Valid Request" or an "Invalid Request" (RX 276A). A "Valid Request" was a request for a cap for a tractor included within the FFPP (Bennett, Tr. 3246; *See* Finding No. 8). An "Invalid Request" was a request [81] for a cap for a tractor not covered by the IH program; for example, diesel tractors, Deere Co. tractors (Bennett, Tr. 3246).

250. Depending on whether the request was valid or invalid, IH sent the farmer one of two letters. If the request was valid, IH advised that the cap would be sent to the farmer's dealer, and that the farmer would then be asked to bring in his old cap and exchange it for a black cap (RX 72, pp. 28–29). If the request was invalid, IH asked the farmer to recheck the tractor information submitted to IH, and if an error was made, to submit a new cap request by completing an enclosed postage-paid card (RX 72, pp. 30–31). In both letters, IH reiterated basic safety warnings and urged proper tractor maintenance (RX 72, pp. 28 and 30; Allen, Tr. 3713–14).

251. IH maintained a running, computerized record of valid requests, caps shipped, and caps exchanged (Allen, Tr. 3715, 3721–22). In each cap shipment IH provided the dealer with a listing of the names and phone numbers of farmers to receive caps from that shipment (Allen, Tr. 3715). Further, the dealer received a card to be filled in by farmer and dealer when the farmer picked up his black cap. The dealer was then to mail the card to IH. The card acknowledged that the exchange had been perfected (Allen, Tr. 3715; RX 72, p. 32). Each month IH sent each dealer a listing of unexchanged caps in that dealer's trade area (Allen, Tr. 3715).

252. After shipping a cap for a particular farmer to a dealer, IH sent the farmer a "PICK UP YOUR NEW GAS CAP NOW" notice. IH also enclosed a brochure containing a gasoline-powered tractor maintenance check list and an exhortation that "your tractor works better when it's in tune," along with explanatory comment. (RX 84A-B; Allen, Tr. 3716).

253. As of February 14, 1982, IH had received 240,957 total requests for caps in the United States and Canada. Of these 215,973 were "Valid Requests" and 24,984 were "Invalid Requests." IH had shipped 213,810 caps. IH dealers in the United States had actually exchanged 169,456 black caps for old caps and IH had shipped 9600 black caps to farmers in Canada, so that a total of 179,056 caps were in farmers' hands (RX 276B; Allen, Tr. 3740–41).

254. Some farmers, despite being notified of the availability of the black cap at their local dealership, have not visited the dealership to

effect a cap exchange. On February 19, 1982, IH initiated a formal procedure whereby dealers are requested to remind farmers by phone call or letter to effect the cap exchange, are authorized to accomplish the cap exchange during field visits, and, if certain conditions are met, will be authorized by IH personnel to mail caps to customers. (RX 278A-D). [82]

255. In addition to caps exchanged, IH dealers and others have sold black caps to farmers (G. Killingbeck, Tr. 5231–32; Heyen, Tr. 5482). IH did not present evidence on the number of caps sold by IH dealers. In this connection, IH cannot know the number of caps sold for installation on IH tractors. The record shows, however, that farmers have purchased black caps, and that purchased caps have been installed on IH gasoline-powered tractors (G. Killingbeck, Tr. 5231–32).

256. The black cap is not essential to respondent's warning program, since if operators adhere to the basic warnings in respondent's Fuel Fire Prevention Program to: properly secure their fuel caps, not remove fuel caps from a hot or running tractor, and keep their tractors properly maintained, then a fuel geysering accident cannot occur (Findings No. 32–33; *Concessions of complaint counsel,* Tr. 2362, 2408, *Transcript of telephone conference* of May 7, 1982).

257. The principal relevance of the gas cap exchange program are two: (1) the fact that an additional safety factor is provided thereby, to supplement the warnings which IH has issued to the operators of its tractors; and (2) the fact that the number of gas caps exchanged provides some measure of the effectiveness of respondent's communication of its warning message.

258. As noted in Finding No. 253, above, there had been 215,973 valid requests received for new black caps by February 14, 1982. When this figure is compared to the number of IH gasoline-powered tractors still in use, they provide some indication of how effective IH's FFPP has been in conveying its warning message to the operators of its tractors.

259. The record contains two estimates of the number of such tractors still in use. Respondent's estimate is 375,000, which it claims to be a high estimate (RF 351, 352). Complaint counsel's expert estimates the number to be 407,694 (Kleyle, Tr. 5423, 5431, 5433). There are valid criticisms for each of these estimates, and neither can be considered precise (CRF 622–24; RF 353). However, both are close enough together to give a "ball-park" estimate which would be useful enough for the purposes of this case—375,000 to 408,000 tractors. The "valid requests" for respondent's new black cap, therefore, represent, at a minimum, over 50 percent of IH's gasoline-powered tractors which were subject to this program and still in use. Considering the fact that of the 1,363,000 of such tractors respondent built, more than 1,085,000

of them were built and sold by 1961 (RX 89H-I), this is certainly a very good record. This is especially so, since it is apparent that all farmers who have read the warning material obviously do not [83] consider the black cap to be essential to their safety and are not so concerned as to order or pick up their free black caps (Finding No. 254; RX 93-15 to 29). This is not surprising in that it is to be expected that many operators would not be likely to remove the gas cap from their tractor if they heard a hissing noise coming from the vent hole, or heard boiling in the tank of their tractor. Some verbatim quotes from the Gas Cap Study made by Chilton Research Services for respondent illustrate this point:

> I never had a problem. I think it's a waste of money. And the fault is with the operator. (RX 93-15)
>
> I don't see no problem with the gas cap. (RX 93-16)
>
> I have been an International Harvester owner for thirty years and I haven't had any problems. I think that the owners who experienced problems with the gas cap must have been stupid or something. Common sense would tell you that you don't remove a gas cap from a hot tractor tank. I don't care if it's a Deere or International Harvester or a Model T Ford. (RX 93-19)
>
> . . . I don't really consider that a hazard if handled with reasonable care. (RX 93-20)

H. *The Effectiveness of IH's Fuel Fire Prevention Program*

260. The combination of materials and methods of communication included in respondent's Fuel Fire Prevention Program of 1980 constitutes an effective program in terms of content and communication. The basic message is contained in the August 1980 letter, which even complaint counsel concede is adequate for this purpose (Finding No. 200). My review of the media advertisements and the communications to leaders in the agricultural community and through the dealer network reveals that this same basic message is repeated simply and clearly—properly secure your fuel cap—do not remove it when the tractor is running or hot—keep your tractor properly maintained—failure to do these things constitutes a fire hazard and endangers your life (RX 71B; RX 72; RX 75; RX 218; [84] CX 248; CX 375; CX 388A, B; Findings No. 186-197, 201-203, 209-212, 215-222, 226-228, 239-242, 244). Dr. Lirtzman, an expert called by respondent was of the opinion that the FFPP constituted an "extraordinarily effective" program (Lirtzman, Tr. 4723). He stated further, "I don't know of any set of circumstances in which such a program in terms of its detail, extensiveness, I might even say forthrightness, has occurred or been attempted even as a consequence of mandated regulation in the United States . . . I think personally, as an expert in this field, it is a

remarkable job." (Lirtzman, Tr. 4723–24). Another expert called by respondent, a farm safety specialist, testified that respondent's FFPP was "very adequate." He added that "I have never seen anything that was as thorough and as complete a program. . . ." (Swanson, Tr. 4810).

261. Therefore, I find respondent's Fuel Fire Prevention Program to be as effective as one could expect in view of the advanced age of the majority of the tractors involved. I find no suggestions from complaint counsel, or their experts, in this record which could reasonably be expected to yield better results. It is obvious that it is unreasonable to expect 100 percent effectiveness of a notice program designed to reach owners and operators of tractors which may be as old as 43 years, and the majority of which are over 21 years old, and many of which may have changed hands numerous times. The over-all concept of respondent's Fuel Fire Prevention Program, considering all of its facets, is well-conceived and designed to obtain maximum coverage (Findings No. 167–253). This fact, combined with complaint counsel's concession that the August 1980 warning letter is adequate, insofar as its wording is concerned, gives ample proof that respondent's program was an appropriate reaction to the "fuel geysering" hazard.

I. *The Killingbeck Incident*

262. It is necessary to give special attention to a fuel fire which occurred on a tractor operated by Gary Killingbeck on May 22, 1981. This is so because the incident occurred after the Fuel Fire Prevention Program was virtually completed and the tractor involved was equipped with the new black cap. (Killingbeck, Tr. 5229, 5233–36).

263. The uncontested facts of record concerning this incident are: Mr. Killingbeck experienced a fire on his tractor on May 22, 1981; his tractor was equipped with the new black cap; and the cap stayed on the fuel tank during the fire (CF, pp. 130–136; RRF, pp. 87–98).

264. Mr. Killingbeck testified that the fire came out from around the gasoline cap, shooting flames higher than his head (Killingbeck, Tr. 5250). Prior to this he had heard a whistling [85] sound and felt pressure coming out of the vent holes in the fuel cap (Killingbeck, Tr. 5248). He then heard a small pop and then there was an explosion (Killingbeck, Tr. 5248). Mr. Killingbeck did not know where on the tractor the pop had occurred. As far as he knew there could have been a collection of vapors underneath the hood sheet where the pop occurred. He did know, however, that the black fuel cap stayed on the filler neck throughout the fire and that no liquid gasoline shot out of the filler neck. (Killingbeck, Tr. 5299). This was a vapor fire (Killingbeck, Tr. 5299).

265. The experts testified in conflicting manner concerning the nature and causes of the Killingbeck fire. Dr. Creighton testified for

complaint counsel that the fire was caused by pressure in the tank which caused vapors to be expelled from the tank (Creighton, Tr. 2395, 2404). Additional vapors and possibly liquid fuel were expelled after the fuel cap went into tang relief, either before or after the explosion (Creighton, Tr. 2404–05). IH engineers who inspected the tractor shortly after the fire, testified that the fire was generated by a leak in the fuel tank at the sending unit, which was located under the hood sheet near the hole where the filler neck emerges (RX 223B-G; Nelson, Tr. 4335–36, 4338–41, 4505; Hillstrom, Tr. 3536–39).[25] IH's engineers also attributed the fire, in part, to poor maintenance of the tractor and modifications which had been made to the tractor (RX 224; CX 391; Nelson, Tr. 4311–19, 4325–26, 4347–50, 4351–63, 4495–97; Hillstrom, Tr. 3526–27, 3537).

266. The burden was on complaint counsel to prove that this incident was a "fuel geysering" accident encompassed by the charges of the Complaint. They have failed to do so. The opinion of Dr. Creighton, at best, would merely be of equal weight to that of respondent's experts. I find no evidence which clearly refutes respondent's theory as to how this accident occurred. Moreover, Dr. Creighton's opinion includes the gushing of liquid fuel from the filler neck, but the only eyewitness, Mr. Killingbeck, states that he did not see this occur (Killingbeck, Tr. 5299). Further, Dr. Creighton did not have as good an opportunity as respondent's engineers to inspect the Killingbeck tractor, since it had already been disassembled when he inspected it (Creighton, Tr. 2382–83) and Dr. Creighton has less experience in farm tractors than respondent's engineers. In fact, he has never conducted a test on any kind of farm tractor (Creighton, Tr. 2183). **[86]**

267. The fact that there was obviously pressure build-up in the fuel tank of the Killingbeck tractor (either before or after the fire began) and that this was somehow related to the fire, bears no relevancy to the charges of the Complaint in the absence of proof that this was a fuel geysering incident. The Complaint charges respondent with failure to warn operators of its tractors of the safety hazard which has been termed "fuel geysering." It does not charge respondent with failure to manufacture a tractor which does not experience pressure build-up in the tank. The required warning was given prior to this fire, and Mr. Killingbeck was exposed to it, but he did not take the time to read it, or inquire about it (Killingbeck, Tr. 5232, 5234, 5282–85; Hillstrom, Tr. 3569–70). Moreover, there is no evidence that the warning would have had any effect in this instance, even if it had been read and heeded.

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[25] The fuel sending unit is a device which transmits electrical impulses to the fuel gauge on the tractor's instrument panel (Hillstrom, Tr. 3533).

J. *The Chilton Study*

268. In the Fall of 1980, respondent decided to conduct a survey of the awareness levels generated by the various communications made in the Fuel Fire Prevention Program (Colwell, Tr. 3624; Dahlman, Tr. 4195). The assignment to perform such study was given to George S. Dahlman, the present Manager of Research and Planning for IH's Equipment Group (Dahlman, Tr. 4194). Mr. Dahlman's career has been spent in agricultural communications and market research, both with IH and in previous employment with an agricultural publication and research firm (Dahlman, Tr. 4183–88). Dahlman selected Chilton Research Services, a subsidiary of the American Broadcasting Company to conduct the survey. He worked with Chilton on designing the questionnaire and selecting a sample audience. (Dahlman, Tr. 4197–4205; CX 393A-D; CX 394A-E; CX 395A-E). A sample audience of 400 owners of IH gasoline-powered tractors was selected; a sample distribution was also selected on the basis of IH's earliest sales records, which indicated that the preponderance of the tractors had originally been sold in the Midwest and Northeast (CX 394A; CX 393A-C; Dahlman Tr. 4201–03).

269. Chilton conducted the interviews in the latter half of February 1981 (Dahlman, Tr. 4206–07; CX 393E). This was between one and five months after IH's ads had appeared in farm trade publications and about seven months after the IH August 1980 warning letter had been sent (Dahlman, Tr. 4206; RX 73H-I).

270. The results of the Chilton study have been cited by both sides. Complaint counsel assert that it illustrates the ineffectiveness of IH's warning efforts (CF 391–407). [87] Respondent cites it to show the effectiveness of its Fuel Fire Prevention Program (RF 537–546). In actuality it does little to prove either point.

271. The Chilton study sought to measure awareness from the point of view of recall (Popper, Tr. 2799).[26] Even complaint counsel's communications expert, Mr. Popper, stated that recall is a rather poor indicator of awareness—even "day-after" recall (Popper, Tr. 2799–2800). Here the recall was not "day-after," but from one to seven months after (Dahlman, Tr. 4206; RX 73H-I; CX 375). In other words a viewer or reader of an advertisement might be well aware of a message transmitted by a communication, but might have a very poor recollection of the particular communication itself (Popper, Tr. 2799–2800).

272. Viewed in this light, the Chilton survey might be slightly tilted in favor of respondent's position. On both an "aided" and "unaided"

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[26] "Recall" is that which a person who views or reads a communication can later retrieve from memory concerning the communication (Popper, Tr. 2799).

recall basis, Mr. Dahlman was able to conclude that 68 percent of the owners of IH gasoline-powered tractors were aware of the hazard warning and free gas cap offer, and 64 percent were aware that IH was the sponsor of the warning and gas cap program (RX 93A; Dahlman, Tr.4208).[27] Complaint counsel deprecate such conclusion, arguing that unaided awareness, which was much lower, is a better test of the effectiveness of these communications (CF 395–401). However, in view of the admitted unreliability of "recall" as a measure of awareness, I find that "recall" measured on both an "unaided" and "aided" basis is a more reasonable indicia of the effectiveness of the communications in question (Finding No. 271).

273. Complaint counsel also point to a "key words" portion of the survey and to verbatim responses given by participants, as evidence of the ineffectiveness of respondent's hazard communications (CF 402–407). However, the results of the survey indicate that the recipients of the August 1980 warning letter were less aware of the potential safety problem and fire hazard than those who had read the later, media advertisements (CX 392P). Since it is conceded that the message of the August 1980 warning letter is adequate, it is obvious that such results [88] only prove Dr. Popper's opinion that recall, especially over a period of time, is a very poor measure of awareness (Findings No. 200, 271).

274. The verbatim responses to the Chilton study reveal a broad gamut of reactions to the questionnaire, from a complete lack of recollection, to a feeling that the whole safety campaign is stupid, since there is no danger to an operator if reasonable care is taken (CX 392; RX 93–13–43; Finding No. 259). This latter reaction indicates that an operator who already knew better than to only partially secure his fuel cap, or remove the fuel cap from a hot or running tractor, especially when there is hissing from the cap or boiling in the tank, was not likely to take the hazard warning too seriously (Finding No. 259).

275. Accordingly, I find that the Chilton study is poor evidence of the effectiveness of respondent's FFPP, but that it does give some indication that respondent's hazard warnings and free gas cap offer were effectively communicated (Findings No. 271–274).

VIII. THE VIOLATION

276. Having found that at least by 1963 and thereafter, respondent knew or should have known that: (1) Its gasoline-powered tractors with the fuel tank located in front of the operator were subject to fuel heating, vaporization and build-up of pressure within the fuel tank

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[27] "Unaided" awareness measures a subject's recollection without being prompted or given information about the subject of the survey (Popper, Tr. 2774).

during their normal operation (Findings No. 10–34, 38–134); (2) A quick release of the pressure under such circumstances, as when the fuel cap is removed or dislodged can result in fuel vapors and liquid fuel shooting or geysering out of the filler neck of the fuel tank spraying the operator and/or the tractor with gasoline which can and has been ignited (Findings No. 19–34, 38–134); (3) Many of the operators and potential operators of such tractors were unaware of this hazard and were removing the fuel cap from hot or running tractors, or were improperly securing the fuel cap so that it might loosen and fly off during the tractor's operation (Findings No. 34–36, 50–53, 55–58, 60–62, 71, 76, 81, 88–90, 92, 94, 104, 117, 121–122, 124, 129, 131, 133, 134); (4) As a result of fuel geysering some operators of such IH tractors were severely burned and one or more operators have been killed (Findings No. 27–28, 54, 58–62, 90, 92, 94, 104, 106, 115, 117, 118, 121, 123, 124, 126, 128–130, 132–134); (5) Fuel geysering is a definite safety hazard (Findings No. 27–28, 38–134; *See especially,* Findings No. 98, 100 and 138); and (6) Fuel geysering accidents were likely to continue unless the operators and potential operators of such tractors were notified of the existence of the hazard and the steps they could take to prevent it (Findings No. 35–134). **[89]**

277. Having further found that: (1) Respondent having such knowledge should have taken action sufficient to apprise the operators and potential operators of such tractors that the safety hazard of fuel geysering existed and the steps they could take to prevent it (Findings No. 38–134, 138, 149–151, 153–156, 163, 167–171); (2) Respondent failed to take such action in 1963 and subsequent years, until 1980 (Findings No. 146–198); (3) Further fuel geysering incidents occurred within the period 1963–1980 which might have been avoided had adequate warning been given (Findings No. 31, 98, 100, 104, 115, 117, 118, 121, 123–129, 133, 134, 138; CX 220); (4) Had the operators and potential operators of such tractors been apprised of this hazard and the steps they could take to prevent it, it might have affected their decisions to purchase new or used IH equipment, or their manner of care and use of such equipment (Findings No. 36 and 37); and (5) Respondent manufactures and distributes, and at all relevant times manufactured and distributed agricultural equipment and accessories and parts therefor, including the tractors in issue and/or the accessories and parts therefor, in commerce, and is, and has been, in substantial competition in commerce with other corporations, firms and individuals engaged in the manufacture, sale and distribution of such products (Findings No. 3–7).

278. It is, therefore, found that such acts and practices, in failing to adequately disclose material facts have had the capacity and tendency to mislead members of the public, particularly those who may

consider purchasing or operating an IH gasoline-powered farm tractor having the fuel tank in front of the operator and that such acts and practices are to the prejudice and injury of the public and constitute unfair or deceptive acts or practices or unfair methods of competition in or affecting commerce, in violation of Section 5 of the Federal Trade Commission Act, as amended.

IX. THE EXPERT TESTIMONY

279. In general, I have had to rely very little on expert opinion in making the above findings. Most of the basic facts involved in this matter have been well documented in the files of respondent. The testimony of operators involved in fuel geysering incidents is also clear and unambiguous and, for the greater part, uncontraverted on the record. My citations to the record in the above findings, although not meant to be exhaustive, are a good indication of the extent to which I have had to rely on expert opinion.

280. Dr. Donald Creighton was qualified on the record as an expert in mechanical engineering. He is currently a professor [90] in the Mechanical and Aerospace Engineering Department at the University of Missouri (Creighton, Tr. 2188; CX 385A). He is a registered professional engineer (CX 385G). He is qualified by his training and experience in the areas of thermodynamics, heat transfer, machine design, fracture mechanics, and other areas of mechanical engineering to testify as to the phenomena involved in "fuel geysering" on respondent's tractors (Creighton, Tr. 2133–40, 2142, 2147–48, 2153–56, 2161–62, 2170–72, 2180, 2213–14, 2219–20, 2243–44, 2262, 2430–31, 2243–44). However, he has never actually conducted a test on any farm tractor (Creighton, Tr. 2183).

281. Wayne Worthington, deceased, did not appear and testify in these proceedings. Complaint counsel were permitted to put in evidence a portion of his deposition testimony from private litigation—*Kraus* v. *International Harvester*, C.A. 79–0609–CV-W–3 (D.C. W.D. Mo. W.D. 1979). Mr. Worthington was apparently a recognized expert in his field (tractor engineering), since he had received several awards (CX 306A, pp. 26–27; McCormick, Tr. 1567) and was even engaged as an expert by respondent in 1963, to assist it in the *Buatte* litigation (CX 52). However, I did not have the opportunity to witness Mr. Worthington's demeanor, nor have him cross-examined as to many facts in this record. Further, the cross-examination in the deposition record was quite sketchy and limited in great part to issues of the *Kraus* case (CX 306A-B). Under the circumstances, I have generally not relied upon his testimony to resolve questions dependent upon expertise. I have, however, relied upon communications from him to

respondent, during the period he was associated with IH, as putting respondent on notice of his opinion and theories (CX 52).

282. Various IH engineers appeared and testified in this proceeding —R. N. Coleman, Erwin Link, Ronald Zitko, John Den Besten, William Schubert, F. A. Waechter, J. F. Ziskal, Robert Reed, George Rezek, James Bennett, William R. Borghoff, Thomas E. Nelson, Herbert D. Sullivan, and Thomas Hillstrom. All were qualified by education and experience to testify as to technical matters involved herein (Coleman, Tr. 945, 950, 954, 1305–17; RX 32; RX 159; Link, Tr. 1966–69; Zitko, Tr. 1934–35, 1940–41; Den Besten, Tr. 1784–87; CX 313; Schubert, Tr. 1873–75, 1911; Waechter, Tr. 1712–15, 2991; Ziskal, CX 379, pp. 5–11; RX 267H; Reed, Tr. 3017–18; Rezek, Tr. 3063–64, 3103–04, 3117; Bennett, Tr. 3125–27, 3134, 3140–44, 3280; Borghoff, Tr. 3991, 3993, 4003, 4005–06, 4093–94; Nelson, Tr. 4301, 4303–04, 4400–01; Sullivan, Tr. 5105, 5107–08, 5113–15, 5117–18, 5184–85; Hillstrom, Tr. 3435–38). In considering their opinions, however, I have been cognizant of the fact that they are, or were, loyal employees of respondent. **[91]**

283. Dr. Edward Popper was received as an expert in marketing communications (Popper, Tr. 2649–50, 2590–92). However, I find that he is not knowledgeable about the special characteristics of the agricultural community, nor has he had any education or experience in the field of hazard communications or hazard labeling (Popper, Tr. 2612–21). He had no training or experience which would qualify him to advise me as to the effect of specific hazard warnings on members of the agricultural community (Popper, Tr. 2616–27, 2639–41). In view of the specialized nature of this community, these are serious defects in his qualifications. Operators of farm tractors have generally been familiar with tractors and their operation since a very early age. They generally do their own maintenance work and are far more familiar with their tractors than, for example, the owner of an automobile is about his car (Heyen, Tr. 5493; Buatte, Tr. 152, 155, 157, 160; Greathouse, Tr. 184–85, 189–90, 195, 202–05; Cameron, Tr. 357–58, 380–81; Shawback, Tr. 569–70, 603–04; Wohletz, Tr. 627, 650–52; Didion, Tr. 667, 670–71, 684–85; Holtz, Tr. 711, 725–27; Guynn, Tr. 873–74, 919–22; D. Jolicoeur, Tr. 754–56, 785–86; S. Jolicoeur, Tr. 812–13; Clowes, Tr. 1826, 1828, 1867–69; Nichols, Tr. 2086–88, 2091; Killingbeck, Tr. 5266–67). [Complaint counsel are quick to point out this fact in connection with their contention that tractor owners and operators don't read their operator's manuals thoroughly (CF 315, 316)]. In order to effectively critique hazard communications directed to such a specialized group, it is desirable that a proposed expert have some awareness of the group's knowledge and sophistication in the areas of information to be communicated, or, at least, that he have some

special knowledge in the area of hazard communications or hazard warning.

284. Respondent, on the other hand, presented two experts in this area. One who was qualified as an expert in hazard warnings and their communication, and the other who was a farm safety expert. I found the testimony of these experts to be helpful, but not necessarily conclusive, in judging the impact of a hazard warning upon the tractor operator, once it was communicated, and in judging the relative comprehensiveness of respondent's Fuel Fire Prevention Program. I did not find their advice helpful, or needed, on the question of whether or not a particular warning or message had been adequately disseminated to the operators of IH tractors, since there was factual evidence in the record upon which I could make such findings—*e.g.*, whether the 1958 Service Slant actually gave notice to operators of the hazard of fuel geysering and the steps necessary to prevent it.

285. Dr. Lirtzman, the expert on hazard warnings, has had considerable experience over the years, both practical and academic, in the field of hazard communications and warnings (RX 252A-E). Since about 1960 he has concentrated in the field **[92]** of product labeling and hazard communications (Lirtzman, Tr. 4588–89). For the past five or six years his major area of specialization has been mass communication and promulgation of safety warnings, hazard warnings, and labels pertaining to consumer and industrial goods (RX 252A; Lirtzman, Tr. 4596). I found his expertise to be of some help in judging the effectiveness of respondent's 1976 and 1980 warning decals and the wording of the media advertisements of IH's Fuel Fire Prevention Campaign, as well as the comprehensiveness of the FFPP as a coordinated mass communication effort.

286. Randall C. Swanson was the farm safety specialist called by respondent. He had extensive practical experience and an educational background in this field (RX 255; Swanson, Tr. 4749, 4751–59, 4764, 4766, 4774, 4779, 4782–83, 4795–97, 4799–4802). I found his testimony particularly helpful in judging the effect of inclusion of agricultural leaders in respondent's warning attempts and in judging the comprehensiveness of IH's Fuel Fire Prevention Program in light of the special nature of the farm community.

287. Dr. Robert Kleyle was called as an expert in statistics by complaint counsel. He was well qualified by training and experience in that field (Kleyle, Tr. 5430–31). He testified as to the number of IH gasoline-powered tractors still in service and in connection with certain evidence respondent had introduced concerning "recall" rates and "recall" effectiveness. I have discounted his opinion of the number of tractors still in operation, since certain of his base data was from a source which characterized it as "subjective" and "unverified"

(Kleyle, Tr. 5447). As for his criticisms of certain "recall" data relied upon by respondent, I have not relied upon such "recall" data in making my findings, so such testimony is not relevant to my decision.

288. Loren D. Lange and Morris Abrams were called by respondent to testify as to the effectiveness of IH's fuel cap exchange program in relation to "recall" programs conducted under the auspices of the United States Consumer Product Safety Commission and the National Highway Traffic Safety Administration. Both had some experience which allowed them to testify as to the "recall" programs conducted through those agencies (Lange, Tr. 4924–25, 4929–30, 4938–40, 4944, 4955; Abrams, Tr. 5571–72, 5574; RX 277D). In general, I did not find significant parallels between the "recall" programs of which these witnesses were familiar or testified and the fuel cap exchange program of respondent. In general, the product age involved and the nature of the campaigns were substantially different than those in the present case (RX 95; RX 111; RX 112; RX 113; RX 117; RX 118; RX 119; RX 120; RX 121; RX 124; RX 142; RX 144; RX 145). It would be impossible to determine from the **[93]** exhibits introduced dealing with such "recall" programs and the testimony of these two witnesses, just what an appropriate response to IH's fuel cap exchange programs should be (*See e.g.*, Lange, Tr. 4939, 4942; Abrams, Tr. 5587–88). On the other hand, the testimony of these witnesses do substantiate the rather obvious fact that the older a product is, the more difficult it is to obtain a high response rate in a recall program (RX 277–O-P, Q; Abrams, Tr. 5595; Lange, Tr. 4947–48). Mr. Abrams' testimony also reveals that there is an available listing of current automobile owners, whereas there is no such available listing of current owners of farm tractors (RX 277–O; RX 32, p. A–237). This obviously makes a "recall" program more difficult to accomplish in the farm tractor industry than in the automobile industry.

289. Richard Hurn is an engineer who was called by respondent to testify as to the trends in gasoline volatility and the effect of gasoline volatility on the phenomenon of fuel geysering (Hurn, Tr. 3892–93). His education and experience qualify him to testify in these areas (Hurn, Tr. 3871–90).

X. OTHER CONTENTIONS OF COMPLAINT COUNSEL

290. Complaint counsel make several contentions that I reject which warrant special attention in these findings.

A. *That Respondent's Tractors With Fuel Tanks In Front Of The Operator Are Defective.*

291. Although not stated explicitly in their proposed findings, a number of the findings which they propose imply that the design of

respondent's gasoline-powered tractors which have the fuel tank in front of the operator is defective (CF 234–259, 481–86, 583, 590) and that the failure to take action to correct such defect is one indicator that a broad order is necessary in this matter (CF 590). The corrections they suggest are either the relocation of the tank to a position behind the operator, or better insulation (CF 590).

292. Complaint counsel themselves have pointed out that tests of respondent's engineers indicated that heat shields and insulation could not completely alleviate the problems of heating of the fuel and pressure in the fuel tank on these tractors (CF 88, 199). [94]

293. Relocation of the fuel tank, which was accomplished on the World Wheel tractors (Finding No. 110), also was not without possible drawbacks. As noted in Finding No. 102, there were both pros and cons to the argument for relocation. The record shows that highway accidents involving tractors is a far more frequent occurrence than tractor fires (RX 32, pp. 6, 16, 17, 86–88, x–xii). It is possible that a rear-mounted tank might prove quite hazardous in a rear-end collision.

294. Most importantly, this case was not a "defect" case. The Complaint does not charge respondent with failure to warn of a defective product, but rather failure to warn of the existence of a fire hazard (Complaint ¶ 8). Therefore, the question of the proper location for a farm tractor fuel tank has not been litigated. Complaint counsel have seized upon certain recommendations of IH engineers to indicate that respondent has been callous in its concern for the safety of its customers. I cannot find this to be the case on the basis of this argument, without a complete litigation of the design problem. The charges of the Complaint neither justified, nor allowed such an inquiry on this record.

295. Moreover, it has been found, based in good part on complaint counsel's concessions, that a properly secured fuel cap cannot come off unless the operator removes it (Finding No. 32). Therefore, as has also been found, if the operator obeys the warnings given in respondent's Fuel Fire Prevention Program a fuel geysering accident cannot occur, no matter where the fuel tank is located (Findings No. 32, 260–261). For all these reasons, complaint counsel's arguments with regard to fuel tank location and other design modifications must be rejected.

B. *That Respondent Waged A Media Campaign Which Diluted The Message Of The FFPP*

296. Complaint counsel also contend that any hazard warning contained in IH's Fuel Fire Prevention Program was diluted by other communications which respondent disseminated during the same period of time (CF 440 *et seq.*). This argument is based on several

statements which IH issued through various channels which generally denied that there was any design defect in IH tractors or that they were made unsafe, if the tractors were properly maintained and the operators followed certain safety rules. Some of them specifically cautioned operators not to remove the fuel cap when the tractor was running or hot and to always properly secure the cap (CX 143C-D; CX 147A-B; CX 156; CX 211A-D). These communications were not part of the Fuel Fire Prevention Program (Bennett, Tr. 3263; Colwell, Tr. 3670). They [95] were used to counteract news stories and other reports which respondent felt misconstrued and misrepresented the facts concerning fuel geysering incidents and to dispel the notion that IH gasoline-powered tractors suffered from a design defect (Colwell, Tr. 3595, 3598–99, 3602, 3611).

297. One of these communications, "Farmer's Safety Is Our No. 1 Concern," received far greater distribution than any of the others involved in this contention of complaint counsel. Approximately 35,000 copies of this pamphlet were distributed. Fifteen thousand were sent to IH employees and retirees in the Chicago area; 11,000 were sent to IH manufacturing plants, mainly in the Midwest; and 9,000 were sent to the six IH sales regions in the United States (Colwell, Tr. 3603). Copies were also sent to the WGN television farm broadcaster in Chicago, whose program is sponsored by IH, to the editor of *Implement and Tractor Magazine* who had recently written on the *Stambaugh* case, and to the editor of *Prairie Farmer*, a farm trade magazine owned by ABC (Colwell, Tr. 3611–12). There was no dissemination of this pamphlet after July 1980 (Colwell, Tr. 3610).

298. One of the sections in this pamphlet, entitled "What About Changes In Fuels?" contained a caution to operators to: tighten the fuel cap securely; never take the cap off or refuel when the engine is running or hot; and don't smoke while handling gasoline (CX 156F).

299. Respondent is certainly entitled to counteract stories in the press, on television, or elsewhere, which might unfairly depict its products as defective, or unsafe. In fact, to prohibit it from doing so would present Constitutional questions under the First Amendment. Complaint counsel have not pointed to any misrepresentation of fact in these communications, but urge in effect, that the message that IH tractors are safe diluted and counteracted the hazard warning in respondent's Fuel Fire Prevention Program (Findings No. 440–447). I find no reliable evidence to support this contention, since I have discounted Dr. Popper's testimony in this regard, as noted in Finding No. 283, above.

300. I find that CX 143C-D, CX 147A-B, CX 156 and CX 211A-D, were not primarily directed to owners and operators of IH tractors and have not been shown to have received significant distribution

among such owners and operators. I also find that they do not contain the message that fuel geysering is not a problem, nor do they contradict or deny the hazard warnings of the Fuel Fire Prevention Program. Therefore, they do not diminish the effectiveness of that Program. [96]

C. *That The August 1980 Letter Was Only Written Under Pressure Of The Commission Investigation*

301. As noted in Footnote 22, above, complaint counsel claim that the August 1980 warning letter sent to operators by respondent (CX 375) was not a voluntary undertaking of respondent, but was only done under pressure of the Commission's investigation. The burden of proof on such a contention is upon complaint counsel. They have failed to carry that burden.

302. Complaint counsel's arguments are based on several points: (1) That Bennett's original plans for a direct mailing to operators envisioned a "fold-out mailer . . . a three-fold 8 1/2 × 5 1/2 brochure in red colors including a message on gasoline safety, a general safety message, a tractor maintenance check list, and a return postcard" (CRB p. 27; citing CX 203P); (2) In the Spring of 1980 IH followed through with this suggestion, only the brochure, "New Facts About Fuels," was sent to dealers, instead of direct to customers (CRB p. 27; citing CX 203V which stated: "Under no circumstances should we delay getting this brochure into customer hands beyond this Spring regardless of whether or not the cap is ready by then"); (3) IH first learned of the Commission's interest on July 1, 1980 (CRB p. 27); (4) The first draft of the 1980 warning letter was prepared on Sunday, August 3, 1980 (CRB pp. 27–28); (5) By this time IH had received a letter officially informing it of the Commission's interest in the matter, that letter being dated July 18, 1980 (CRB p. 28); and (6) At a meeting on August 6, 1980, complaint counsel presented respondent's counsel with a draft of a proposed warning letter and, only after having reviewed the proposed letter of Commission counsel, IH's counsel then produced its proposed draft of the IH warning letter (CRB p. 28). On the basis of these circumstances, complaint counsel urge that it would be contrary to the evidence to find that the August 1980 warning letter was voluntary (CRB p. 28).

303. Complaint counsel's recitation of the history of this letter omits certain record evidence. As early as the Spring of 1979, IH's plans for its Fuel Fire Prevention Program included a number of components, including a direct mailing to operators and a supplemental media advertising campaign, both of which would be related to the distribution of the new fuel cap (Finding No. 175; CX 121; CX 123; CX 125). As complaint counsel note, Mr. Bennett became concerned in the Fall

of 1979, when it was apparent that the cap would not be ready for distribution by the next Spring, that the safety message would be unduly delayed. He then recommended that IH "proceed with a campaign to provide information and instruction regarding gasoline [97] volatility and safety precaution to the agricultural community" (CX 141). His communications gave no indication that the gas cap exchange program would not still entail direct contact with operators and a supplemental media advertising program (Findings No. 182, 183). Complaint counsel then jump to the conclusion that the brochure distributed in the Spring of 1980 was to replace the direct mailing to operators, since it took the same general format as the mailing originally planned in the Spring of 1979 (CX 123; CX 153; CRB p. 27). However, this omits consideration of the fact that the fuel cap still had to be distributed and that the direct mailing and media advertising were a key part of that exchange program (Findings No. 174, 175, 199, 205). There is no testimony or other evidence to support complaint counsel's contention that these portions of respondent's gas cap exchange program had been abandoned, except for the fact they were not effected in the Spring of 1980.

304. Moreover, the notice of the Commission's interest in the "fuel geysering" problem on July 1, 1980, was quite informal and did not spell out the extent of the Commission's interest. It came through a chance encounter at a county courthouse in Illinois, when a Commission attorney told one of IH's outside counsel that the Commission was looking on a preliminary basis into the tractor fire issue. (IH's Supplemental Finding 623; Complaint Counsel's Supplemental Finding 641). On July 9, 1980, there was an additional telephone discussion between IH's outside counsel and Mr. Drost of the Commission's staff which confirmed the fact that the Commission was making a preliminary investigation into this problem (Complaint Counsel's Supplemental Finding 642). Formal notice of the Commission's investigation and the extent of its interest therein was not mailed until July 18, 1980 (Complaint Counsel's Supplemental Finding 643).

305. However, on July 10, 1980, before the mailing of such formal notice, Mr. Bennett had prepared outlines of the elements of the gas cap exchange program, which included a direct mailing to customers and media advertising (RX 65A-I). In this regard, it must be noted that Mr. Bennett had been notified by memo of May 30, 1980, after the Spring safety campaign, that the first production models of the new fuel cap would be available on July 14, 1980 (RX 61).

306. Another step in this process was also accomplished prior to formal notification by the Commission that an investigation was under way. The media advertising program was well-developed by

July 15, 1980 (CX 390C-L). It also made mention of the mailing to customers (CX 390L).

307. A draft of IH's warning letter was prepared on August 3, 1980 and revised on August 4, 1980 (CX 216A, F, Z2–50). A meeting was held between Commission counsel and IH counsel on August 6, 1980, at which complaint counsel suggested a proposed [98] letter to customers and respondent revealed its plans to send its own warning letter (IH's Supplemental Finding No. 626; Complaint Counsel's Supplemental Finding 649). Complaint counsel made suggestions for certain language changes in IH's version of the warning letter, which were included in respondent's final letter. Respondent urges that such changes were "minor" and complaint counsel have not contested this claim (IH's Supplemental Finding No. 627; Complaint Counsel's Response, p. 4).

308. When all of these facts are considered together, it is no longer apparent that the August 1980 warning letter was a reaction to the Commission investigation. Although it is admitted that Commission counsel had a "minor" effect on the final wording thereof, there is a logical pattern from the inception of respondent's FFPP in the Spring of 1979 through to August 1980, which would explain the derivation of the August 1980 letter on a purely voluntary basis. Although complaint counsel have been able to point to a similarity between the timing thereof and the Commission's notice of investigation, they have produced no concrete evidence that the August letter was the result of their investigation. Even as to the wording of the letter, they can only claim to have had a "minor" effect. Since complaint counsel have the burden of proving their contention that the letter was involuntary, and they have failed to carry that burden, I must find that the August 1980 warning letter and the subsequent media campaign were voluntary acts of respondent.

XI. DISCUSSION

I have found that at least by 1963 and thereafter, respondent knew or should have known that its gasoline-powered tractors with the fuel tank located in front of the operator were subject to fuel heating, vaporization and build-up of pressure within the fuel tank to such a degree that, under certain circumstances, when the fuel cap is removed or dislodged while the tractor is running or still hot, liquid fuel and fuel vapors might shoot or geyser out of the filler neck, spraying the operator and/or the tractor with gasoline which can and has been ignited (Finding No. 276). I have also found that respondent knew or should have known by that time that many of the operators and potential operators of those tractors were unaware of this hazard and were, as a result, removing the fuel cap from hot or running tractors, or improperly securing the cap so that it might loosen and fly off, thus exposing themselves to the hazard of fuel geysering, and that some of such operators had been seriously injured, and even killed, as a result (Finding No. 276). **[99]**

The fact that many operators were unaware of this hazard must be considered excusable ignorance. Despite respondent's long experience with fuel geysering and its causes, even some of its own engineers were still unaware of this hazard in the late 1970's. One of respondent's engineers stated in February 1979 that "he couldn't conceive of a fuel geysering" (CX 299F); this was based on 40 years experience of operating and being around tractors (Sullivan, Tr. 5143–44). Another, Mr. Borghoff, testified herein that he didn't believe geysering could occur even under abnormal conditions (Borghoff, Tr. 4130). Two other IH engineers, Mr. Drummond and Mr. Gaul, testifying in the *Stambaugh* litigation in 1979, indicated that they didn't think fuel geysering could occur unless extraordinary circumstances existed (CX 285E; CX 286D-G). If these IH engineers could not imagine a fuel geyser, how could operators with far less expertise be expected to know of this danger?

Mr. Drummond admitted that he didn't think farmers expected the gas to "bubble up" when they removed the fuel cap (CX 285E). Mr. Gaul admittedly knew that farmers were taking the fuel cap off of hot tractors (CX 286G). This same knowledge, on the part of IH, was repeatedly evidenced in its internal documents (CX 19A; CX 27B; CX 28A–B; CX 28F; CX 40; CX 41; CX 44A; CX 46D; CX 49A-B; CX 52; CX 53; CX 62; CX 89; CX 90; CX 91A-B; CX 101A-B, E, F; CX 110; CX 111; CX 119A-B; CX 138A-B; CX 291H). In fact, it knew that its own testing personnel sometimes removed the fuel cap from a hot or running tractor (Findings No. 37, 53).

Under the circumstances, respondent certainly was aware of the fact that there was a "hidden" safety hazard involved in the operation of any of the tractors here in issue. It knew that the temperature of the gasoline and the vapor pressure in the fuel tanks of these tractors were frequently building up to the point where a serious hazard existed, if the fuel cap were removed or dislodged (Findings No. 20, 29–31, 44, 38–134; *See especially,* Findings No. 51, 96, 98, 100). It also knew that many operators, indeed some of its own engineers, were not aware of this hidden hazard (Finding No. 36) and were removing the fuel cap from hot or running tractors (Findings No. 34, 53, 276).

Commission precedent is quite clear on the duty to disclose such a hidden hazard. The Commission has held that the failure to make such disclosure is both deceptive and unfair. *Firestone Tire & Rubber Co.,* 81 F.T.C. 398, 456 (1972); *Stuppell Enterprises,* 67 F.T.C. 173 (1965). *See also, Porter & Dietsch* v. *F.T.C.,* 605 F.2d 294, 308 (7th Cir.

1979), *cert. denied, sub nom., Pay 'n Save* v. *F.T.C.*, 445 U.S 950 (1980); *Simeon Management Corp.* v. *F.T.C.*, 579 F.2d 1137, 1145–46 (9th Cir. 1978). [100]

Even where no explicit safety claim has been made, as in this case, the Commission has found that the failure to disclose such a hidden, or unknown hazard is a deceptive practice. *Stuppell Enterprises*, 67 F.T.C. 173, 187, 188 (1965). In selling its tractors, respondent gives an implied warranty that it is safe to use for its intended use, save any obvious or well-known defects or hazards. *Stuppell*, at 187, 188; *Seymour Dress & Blouse Co.*, 49 F.T.C. 1278, 1282 (1953); *Academy Knitted Fabrics Corp.*, 49 F.T.C. 697, 701 (1952).[28]

In this case it is quite clear that IH's gasoline-powered tractors had a hidden hazard, that respondent knew of such hazard at least by the year 1963 and failed adequately to inform its customers of that hazard until 1980. Thus, at least by 1963 and thereafter, respondent had a continuing duty to make adequate disclosure of the hazard of fuel-geysering to the operators of its tractors and failed to do so. This is a deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act. *Stuppell Enterprises, supra; Firestone Tire & Rubber Co., supra*, at 456.

This failure is also an unfair act or practice under Section 5 of the Federal Trade Commission Act. Respondent contends that there can be no unfairness because the operators of its tractors could have avoided injury by observing certain safety rules. (RB p. 4). This argument presupposes that the operators of its tractors have the basic information necessary to avoid such injury. In this case, it is clear that many tractor operators did not have this information (Finding No. 36) and that respondent was aware of this fact (CX 285E; X 286G). IH was also well aware that a definite safety hazard existed if the operators were not aware of the possibility of fuel geysering and the steps which should be taken to prevent it (Findings No. 37–134; CX 48D; CX 55B; CX 57A; CX 58B). Under less urgent circumstances, the Commission has found the failure to disclose safety hazards to be an unfair act or practice. *See, Firestone Tire & Rubber Co., supra*. [101]

Respondent's failure to inform also meets all of the criteria for finding "legal unfairness" referred to in *Horizon Corporation*, 97 F.T.C. 464, 849–50 (1981). That decision cites to the letter from Federal Trade Commissioners to Senators Wendell H. Ford and John C. Danforth (December 17, 1980) as delineating the Commission's views of the boundaries of its consumer unfairness jurisdiction (Slip Opinion, p. 62). The criteria enunciated therein were two: the existence of unjustified, substantial consumer injury and the violation of established public policy. Further, the consumer injury had to meet three tests: it must be substantial, it must not be outweighed by any countervailing benefits to consumers or competition, and it must be an injury that consumers themselves could not reasonably have avoided. As to the first two tests for consumer injury, there is no real issue in this case. The physical injuries sustained by some of the operators of these tractors were very substantial and there was no contention by respondent that there were countervailing benefits which outweighed them. The "reasonable avoidance" argument has been disposed of in the discussion above, so IH's failure to disclose the safety hazard in question meets the first of the two criteria.

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[28] Nor do respondent's operator's manuals in any way abrogate this implied warranty. (RB pp. 7–8). The vast majority of the operator's manuals for the tractors in question did not even contain instructions against removing the fuel cap when the engine is running or hot (Findings No. 148, 150, 151, 259), let alone inform the operator of the existence of the hazard of "fuel geysering." Moreover, respondent well knew that many operators didn't read their operator's manuals fully (Finding No. 153). Obviously, the operator's manuals cannot vitiate the implied warranty against unknown safety hazards, under these circumstances.

As for the second criterion, the letter to Senators Ford and Danforth (Exhibit 2 to *Memorandum In Support Of Opposition To Complaint Counsel's Motion To Strike,* January 7, 1981), points out that the "violation of public policy" criterion can be applied two ways: "to test the validity and strength of consumer injury, *or less often,* it may be cited for a dispositive legislative or judicial determination that such injury is present." (Letter, p. 9). (Emphasis added). The letter also makes it quite clear that the Commission is not throwing out its past case law in enunciating these criteria, but that, rather, these criteria are the result of the evolution of the definition of "unfairness," as a result of such case law. In fact the Commission states therein: "In response to your inquiry we have therefore undertaken a review of the decided cases and rules and have synthesized from them the most important principles of general applicability. Rather than merely reciting the law, we have attempted to provide the Committee with a concrete indication of the manner in which the Commission has enforced, and will continue to enforce, its unfairness mandate." (Letter, p. 2).

When the "violation of public policy" criterion is applied in the manner thus described by the Commission, there can be no question that respondent's failure to inform is contrary to public policy and is an unfair act or practice in violation of the Federal Trade Commission Act. The validity and strength of the consumer injury herein is beyond doubt. If "public policy" **[102]** is a test of this criterion, then conversely the extent of the consumer injury must be a test of the "public policy" criterion.[29] The "violation of public policy" criterion in matters of this kind has been firmly established in Commission case law, which the Commissioners expressly retained as precedent in their letter to Senators Ford and Danforth. For example, the *Firestone Tire & Rubber* case, *supra*, stated that such conduct was an unfair act or practice and, thus, a "violation of public policy." In doing so, it cited to earlier cases, such as *Stuppell, supra; Novel Mfg. Corp.*, 60 F.T.C. 1748 (1962) and *Fisher & Deritis*, 49 F.T.C. 77 (1952) as requiring affirmative disclosure of safety hazards, even where no affirmative safety claim has been made for a product, and as finding the failure to make such affirmative disclosure to be an unfair or deceptive practice.

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[29] The public policy question in this case is obviously closely related to the question of the avoidability of the consumer injury, since its prime use in finding "unfairness" is to test the validity and strength of such injury (Letter, p. 9). Therefore, the determination of public policy is principally related here to the question of whether the injury can be readily anticipated by the customer or user, so that he reasonably can be expected to avoid it. As noted above, the record evidence establishes here that for many of the operators of the tractors in issue the

(footnote cont'd)

Therefore, there is no need to look to the numerous state judicial decisions and other authorities cited by complaint counsel and respondent to determine whether respondent's act or practice is a "violation of public policy." That determination has already been made in *Firestone* and *Stuppell* and other Commission cases, where it has been found that if consumers are uninformed about the risks related to the use of a product, it can lead to personal injury and economic loss, and protection against such loss is in the public interest. "Thus, the Commission has frequently decided that the omission of product safety information is an *unfair* and deceptive practice." *Firestone* case, at 456. (Emphasis added).

One case cited by respondent, *Parsonson* v. *Construction Equipment Company*, 386 Mich. 61, 191 N.W. 2d 465 (1971), merits some discussion, since respondent has placed heavy reliance thereon (RB pp. 9–10, RRB pp. 5, 7, 17, 20, 29, 31, 32, 77, 92). Such reliance is misplaced. First of all, *Parsonson* **[103]** is a product defect case, not a hazard warning case, a distinction which even the Michigan courts find significant. *See e.g., Graham* v. *Joseph T. Ryerson & Sons*, 292 N.W. 2d 704 (1980). Then too, the *Parsonson* case was decided on the basis of the "latent-patent" rule for design defect cases, which has apparently been rejected by Michigan courts in later years. *Casey* v. *Gifford Wood Company*, 232 N.W. 2d 360, 365 (1975); *Owens* v. *Allis-Chalmers Corporation*, 268 N.W. 2d 291 (1978).

Respondent quotes a passage from the *Parsonson* decision, which states: "Every adult person having a reasonable measure of intelligence . . . knows better than to open a partly filled gasoline tank when there is some or any nearby source of ignition. Assuredly this is true when the opening is within inches of an already heated and continuously running engine." (*Parsonson*, at 471). Aside from the legal infirmities of the *Parsonson* case as noted above, respondent does not explain some of the facts of this case which clearly distinguish it from

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hazard was unknown, was not reasonably to be anticipated and thus could not be expected to be completely avoided.

the present situation. In addition to the fact that the equipment in issue there was a much different device than a farm tractor, the decision in *Parsonson* shows that the asphalt-laying machine in question was a unique, one-of-a-kind device. It had been designed to the particular specifications of a previous owner. (*Parsonson,* at 467). Therefore, there was no history of prior, similar accidents to put the defendant in that case on notice that a latent or hidden hazard existed in the use of the device. Thus, the court did not consider whether a duty to warn could arise, but only whether there was a patent or a latent defect in the design of the machine.

If respondent wishes to rely on Michigan judicial decisions for guidance as to the public policy question in the instant case, it should look to other more recent cases dealing with the question of hazard warnings. In *Graham* v. *Joseph T. Ryerson and Sons, supra,* the Court was dealing with the question of the duty to warn a group of experts (tire repairmen) of a hazard connected with the repair of certain truck tires. It distinguished the *Parsonson* case by noting that the "duty to warn" issue had not been raised therein (as well as questioning whether the "latent-patent" test was still the rule of law) (292 N.W. 2d, at 706). The Court in the *Graham* case held:

> If members of the particular trade or profession commonly engage in a dangerous practice, the manufacturer's knowledge of the conduct may give rise to a duty to warn . . . In the instant case there was ample testimony that it was the common practice of diesel mechanics, Graham and others, to inflate tires in order to elevate the vehicle. We must assume that **[104]** defendant was aware of this practice since it had been informed of about 40 similar blowout incidents. In light of this knowledge in particular . . . we find a question exists as to the duty to warn even tire repairmen of the special danger involved."
> (at 707).

Moreover, in dealing with the apparent awareness on the part of tire repairmen that there was some danger in their practice, this court stated:

> Consciousness of a vague danger, without appreciation of the seriousness of the consequences may require the manufacturer to provide warning. . . .
> (at 708).

Another Michigan case, *Owens* v. *Allis-Chalmers Corporation, supra,* held that a plaintiff may establish a question of fact as to a manufacturer's breach of duty by showing "that the design choice of the manufacturer carries with it a *latent* risk of injury *and* the manufacturer has not adequately communicated the nature of that risk to potential users of the product." (268 N.W. 2d, at 295) (Emphasis in original).

Therefore, when a closer look is taken at the facts of the *Parsonson* case and its precedential value in light of other Michigan cases, it can be seen that its citation by respondent does not detract from the Commission precedent which I have cited above.

Accordingly, respondent's act or practice of failing to adequately inform the owners and operators of its tractors of the safety hazard termed herein as "fuel geysering," once such safety hazard became known to it, was to the prejudice and injury of the public and constituted an unfair or deceptive act or practice, or an unfair method of competition in or affecting commerce, in violation of Section 5 of the Federal Trade Commission Act, as amended.

XII. ORDER UNNECESSARY

I have found that respondent has now made adequate disclosure of the safety hazard known as "fuel geysering" which is connected with the operation of its gasoline-powered tractors having the engine in front of the operator. (Findings No. 167–261). I have also found that neither complaint counsel, nor **[105]** their experts, have suggested any type of further notification which could reasonably be expected to improve on that notice already given in 1980 (Finding No. 261). Therefore, there does not appear to be a need for an order in this case.

In so finding, I am cognizant of the fact that complaint counsel have suggested order provisions which would cover all agricultural equipment and which would require record keeping and the preparation of customer and operator lists which would be useful in connection with the disclosure of any later discovered safety hazards with regard to IH's farm equipment. However, the facts of this case make the application of an order to agricultural equipment other than the tractors in issue too broad, and the record keeping and customer list requirements are unnecessary, if not too onerous, under present circumstances.

First, it must be remembered that respondent has not produced and distributed gasoline-powered tractors of any type since 1978 and does not appear likely to do so again in the future (Finding No. 116). In fact, it has not produced a great volume of the tractors in issue since the late 1960's (Findings No. 107, 116). The hazard involved in this case is rather unique and does not pertain to any of the other farm equipment produced by respondent. Therefore, an *all farm equipment* order herein appears to be primarily punitive in nature.

This is especially so when it is noted that there are a great number of hazards involved in the use of farm equipment, including tractors. The evidence shows that most of the these hazards are better known and more prevalent than fuel geysering. A Department of Transportation study in evidence lists a number of these hazards and indicates their prevalence (RX 32, pp. 6–7, 11, 14–15, 17). Fuel geysering is not even listed, as such, among those hazards, but is only included among the three percent remaining, unspecified types of farm tractor accidents. It appears from this study that most of these hazards are more obvious and better known than "fuel geysering." However, this fact would not make an *all farm equipment* order more reasonable, even when the savings clause suggested by complaint counsel is included.

At the end of Part II (A) of their proposed order, complaint counsel have inserted a paragraph stating:

> Respondent need not disclose information concerning a safety hazard if the information which is set forth in Paragraphs I.B.1 through I.B.3 of this Order (the safety hazard notice) is **[106]** immediately apparent to the operator of the equipment.

Far from lessening the burden on respondent of complying with their proposed order, this clause merely opens up a broad controversy as to what safety hazard on farm equipment is "immediately apparent to the operator." It is also hard to imagine any savings clause which would be more efficient in eliminating unnecessary compliance expense for respondent, save an actual listing of each and every type of hazard to which the order need not apply. The record does not supply sufficient evidence to formulate such a list and this Commission does not have the expertise to provide such a list in the absence of an evidentiary record.

To impose upon respondent the burden of issuing hazard warnings about every possible farm equipment hazard would be onerous and extremely punitive. The record shows that IH's Fuel Fire Prevention Program cost it about $2.8 million (Finding No. 181). To require such an expenditure (which complaint counsel still urge to be inadequate) in the cases of tractor upsets, falls from tractor, crushed (other than runover), runovers, motor vehicle collisions and power take-off accidents (getting articles of clothing caught in the driveshaft), not to mention numerous other hazards, would possibly put this financially troubled company out of business.[30]

The operation of farm tractors and other related farming equipment is a hazardous occupation (RX 32). To require the identification of all present and future hazards and the issuance of warnings concerning them, without the existence of an evidentiary record (such as in the present case) that identifies a particular hazard as a "hidden" one which the operator cannot reasonably be expected to know about and avoid, would therefore be punitive, not preventive. It imposes the risk of untold unnecessary expense and threatens the very existence of respondent as a going concern. It will certainly not assist the operators of IH's gasoline-powered tractors, if the Commission pushes this company into bankruptcy, thus eliminating it as a source of parts and service, as well as possible consumer redress.

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[30] The listed hazards account for 97% of all farm tractor accidents according to the Department of Transportation study (RX 32, p. 17).

Nor can the record keeping and customer listing provisions of complaint counsel's proposed order be justified. As of 1972, [107] respondent set up a system of central record keeping for farm accidents which should prove adequate for any future needs. (Finding No. 158). Obviously, the possibility of private damage suits and its past experience are sufficient reason for IH to keep apprised of such accidents. There appears to be no good reason to require it to search out accident reports in state agency files and newspaper morgues.

The preparation of lists of operators would also be unnecessarily punitive. Used tractor sales are not easy to track down and the preparation of such lists might be a very expensive undertaking. (Findings No. 154, 204–206; Gast, Tr. 3754–55; Purdy, Tr. 3807–08, 3812). It would also require work and expenditures by independent dealers who are not a party to this proceeding and who could not be encompassed within a Commission Order. Again, it does not make sense to impose onerous burdens on this respondent, now that adequate notice has already been given and the tractors in issue are no longer being produced.

To summarize, I am mindful that the continuing existence of IH in manufacturing and distributing parts for these tractors and being available to settle consumer claims is far more effective relief than an order which runs respondent out of business. The only hazard at issue herein was that of "fuel geysering" on certain gasoline-powered tractors. The circumstances of this case do not appear to call for any further action than respondent has already taken and is continuing to take (Findings No. 223, 239, 242, 244–245, 248, 254, 260–261).

Accordingly, I find that although a violation has been found, no order is necessary.

XIII. CONCLUSIONS

1. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and over respondent.

2. The Complaint herein states a cause of action and the proceeding is in the public interest.

3. The aforesaid acts and practices of respondent as found in the foregoing Findings Of Fact were and are to the prejudice and injury of the public and constituted, and now constitute, unfair and deceptive acts and practices and unfair methods of competition in or affecting commerce in violation of Section 5 of the Federal Trade Commission Act, as amended. [108]

4. Since respondent has now issued an adequate warning of the existence of the hazard of "fuel geysering" and the steps which should be taken to prevent it, no order is required.

OPINION OF THE COMMISSION

By **Douglas**, *Commissioner*:

This matter presents the issue of when and under what circumstances a manufacturer has a duty to notify customers about hidden hazards in his product. The complaint is directed against International Harvester, a firm producing a diversified line of farm equipment. It charges that Harvester's gasoline-powered tractors were subject to a phenomenon known as fuel geysering—the forceful ejection of hot fuel through a loosened gas cap. The complaint further charges that fuel geysering could result in serious fires, sometimes involving the tractor operator; that Harvester was aware of this fact for many years; that the firm did not adequately notify its customers of the danger; and that the operators therefore took inadequate measures to protect themselves.

The Administrative Law Judge found that this pattern of omissions was deceptive, I.D. 100,[1] an unfair consumer practice, [2] I.D. 100–04, an an unfair method of competition, I.D. 104. The ALJ also found, however, that Harvester had begun to issue adequate warnings in 1980, and therefore concluded that a Commission order to do so would not be necessary. Both parties have appealed from this decision. Harvester has appealed the finding of liability, and complaint counsel has sought review of the decision not to issue an order.

We affirm in part and reverse in part. While failure to disclose certain material facts may cause consumer injury and lead to liability under Section 5, it is important to distinguish between the circumstances under which such omissions are *deceptive*—in that they are likely to cause injury to consumers by affirmatively misleading their informed choice—and the circumstances under which they amount to an *unfair practice*—one which causes substantial, unavoidable injury to consumers that is not outweighed by any countervailing benefits. We do not find that the facts describe a practice which causes injury by deception, and so we reverse that conclusion of the initial decision.[2] We do find that the facts describe a situation which is an unfair practice, however, and therefore affirm that part of the initial decision. We also agree that under the circumstances of the case a specific corrective order will be unnecessary. [3]

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[1] In the remainder of this opinion the following abbreviations will be used:

I.D.F. – Initial Decision Finding of Fact No.
I.D. – Initial Decision Page No.
Tr. – Transcript of Testimony Page No.
CX – Complaint Counsel's Exhibit No.
RX – Respondent's Exhibit No.
CPF – Complaint Counsel's Proposed Finding of Fact No.
RPF – Respondent's Proposed Finding of Fact No.
CR – Complaint Counsel's Reply to Respondent's Proposed Findings of Fact
RR – Respondent's Reply to Complaint Counsel's Proposed Findings of Fact
CAB – Complaint Counsel's Appeal Brief Page No.
RAB – Respondent's Cross-Appeal Brief Page No.
CaB – Complaint Counsel's Answering Brief Page No.
RaB – Respondent's Answering Brief Page No.
CRB – Complaint Counsel's Reply Brief Page No.

Our discussion of these issues will be divided into five principal sections. The first section summarizes the basic facts of the case. The second section outlines the general legal principles by which omissions and mandatory disclosures are judged. The third section applies this law to the specific circumstances of the case, with separate discussions of deception and unfairness standards. The fourth section considers some of the collateral legal issues raised by the appeals, such as mootness and undue delegation. Finally, the fifth section examines the question of relief.

I. THE FACTS

The facts in this matter are not seriously in dispute. The evidence shows that Harvester tractors were subject to fuel geysering under certain conditions, and that the company knew of this for seventeen years before directly notifying its customers. The evidence also shows that such accidents were relatively rare and could be avoided entirely by following certain safety rules.

These facts are clearly and thoroughly reviewed in the decision of the Administrative Law Judge. They are agreed to, in [4] at least their principal contours, by all the litigants.[3] On the basis of this history and our own review of the record we adopt the ALJ's findings of fact as our own, except where specific differences may appear in the course of our opinion. The principal issues in this case then revolve around the legal construction that should be placed on these events.

A brief synopsis of the facts will nonetheless be helpful as an introduction to the remaining sections of the opinion. "Fuel geysering" is a phenomenon in which hot liquid fuel is forcibly ejected upward through the filler cap on a tractor gas tank. I.D.F. 19. It can occur because gasoline is a volatile fuel with a boiling point that begins at about 95-97° Fahrenheit.[4] This temperature is easily reached in ordinary use, since a Harvester fuel tank is located immediately above and behind the engine, where it is subject to both direct engine heat and the current of hot air from the radiator.[5] I.D.F. 9–10. Fuel at this temperature can begin to boil. If the fuel vaporizes more rapidly then it can be vented, pressure will begin to build up in the tank. I.D.F. 13. This vapor pressure can suppress further **[5]** boiling, and energy will then continue to build up in the tank in the form of still higher temperatures in the liquid mass of fuel. I.D.F. 19. If the pressure is suddenly released, as through the sudden removal of the fuel cap, the accumulated heat energy can cause a quantity of gasoline to suddenly boil, sending both fuel and vapors up through the filler neck. I.D.F. 19

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[2] As we discuss below, most Section 5 cases charging omissions of material fact are properly characterized as involving deception. Those cases are not called into question by today's decision.

[3] *See* RAB 3; *cf.* CAB 1-2 (taking issue primarily with the Administrative Law Judge's legal conclusions).

[4] Gasoline is actually a blend of different hydrocarbons that vaporize at various temperatures. The first to vaporize have a "dominant influence" on fuel volatility. I.D.F. 12.

A fuel geyser can reach to a height well above the tractor and its operator. In one test that Harvester conducted the geyser shot twenty feet high and the tank lost seven gallons of fuel. I.D.F. 23. A farmer who experienced fuel geysering described it in these terms: "It was frothy-looking—it appeared to be a frothy-looking orangeish white mass, and it just went up like that." Cameron, Tr. 402.

The gasoline sent up from the tank may fall back on the operator, soaking him with raw flammable fuel. This hot fuel can itself cause severe burns. But the great hazard of fuel geysering is, of course, fire. I.D.F. 24. Potential sources of ignition are numerous. Heat from the exhaust manifold, sparks from the generator, or flame from the muffler can all touch off the liquid gasoline. I.D.F. 25. Fire does not occur in all cases, but it is always a danger, and it can be nearly instantaneous when it does come about. One witness testified:

> Well, the minute I got sprayed with gas, I reached for the switch to shut the motor off. By that time, it had ignited. I was one ball of fire. (Shawback, Tr. 583; *see* I.D.F. 26.) **[6]**

Serious injury and death have resulted from such fires. The record contains evidence of more than 90 fuel geysering incidents involving Harvester tractors. I.D.F. 29; CX 220A-K. Testimony at trial identified twelve incidents in which there were significant burn injuries. I.D.F. 27. In one of these cases—that of Charles Kraus—the victim died. *Id.* Harvester acknowledges that two additional deaths have occurred in other fuel fires that may have involved geysering.[6] Imperfect data collection over the years makes it probable that there have been additional incidents of fuel geysering beyond those that are shown on the record. I.D.F. 29.

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[5] This is not a defects case, however, and the complaint does not charge that this design was faulty. Other tank locations presumably have drawbacks of their own, such as increased vulnerability in collisions. The charge is instead that the inherent drawbacks of this particular design were not adequately disclosed.

[6] *Supplemental Memorandum in opposition to Complaint Counsel's Motions for Leave to Submit Additional Evidence on the Issue of Public Interest,* July 21, 1981, pp. 9–11; I.D.F. 27. In these additional cases the origin of the fires was difficult to determine, and they may have been due to causes other than geysering.

These dangers and injuries could have been avoided, however, if the tractor operators had observed a few relatively simple precautions. The most basic precaution was to keep the fuel cap securely fastened, and not to remove it while the tractor engine was running or hot. Some witnesses at these hearings did testify that their fuel caps simply "blew off" while their tractors were running, without their having touched them. The ALJ found otherwise, however, concluding that a properly secured fuel cap cannot be dislodged by internal pressure, and that such cases must have been due to operator removal, improper closure, or poor maintenance that prevented proper cap seating. I.D.F. 32–33. We agree with the ALJ's assessment of the evidence. As a result, **[7]** operators could remain safe simply by leaving their caps secured.[7] For many years the operating manuals had warned tractor owners to do just that.

There are, on the other hand, a number of factors which incline operators toward opening the caps. Some of the older models of Harvester tractors had no fuel guage, so it was common to open the cap to check on fuel level. I.D.F. 34. More importantly, the symptoms of excessive tank pressure tend to resemble the symptoms of fuel exhaustion. These include "vapor lock" caused by fuel vaporizing in the fuel line or carburator, which can cause the engine to sputter or stop; surging of the engine as pressure forces extra fuel into the carburator; and stalling of the engine due to flooding when this extra fuel flow becomes excessive. I.D.F. 18. Any of these symptoms might lead the operator of even a modern, gas-gauge-equipped tractor to stop and visually check his fuel level. In doing so he is encouraged by the sense that this action entails little risk. The operator knows enough to ensure that open flame does not come near the gas tank, and being unaware of the potential for a fuel geyser he took no particular steps to avoid it. I.D.F. 35–37.

By 1955 Harvester was aware of the pattern of accidents that had begun to develop. In that year reports of fuel geysering incidents began to come to the firm's attention; its engineers came to realize that gasoline in tractor tanks was heated to the **[8]** boiling point; and the firm began to conduct systematic tests to identify the factors that caused geysering.[8] In 1957 the firm received its first report of a personal injury resulting from a fuel geysering. I.D.F. 54. By 1963 it began to become involved in private damage suits for fuel geysering injuries. In preparation for these trials Harvester carried out further testing, engineering reviews, and studies of the files of reported geysering incidents. I.D.F. 91–94. For this reason the ALJ concluded that by 1963 Harvester was on notice of the risks of fuel geysering, and under an obligation to inform its tractor operators of this fact and of the steps they could take to prevent it. I.D.F. 276.

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[7] Poor general maintenance may also have been a factor in some geysering incidents, I.D.F. 17, but geysering could occur on even a well-maintained or new tractor. *See* Nichols Tr. 2090–93; Sullivan Tr. 5190.

[8] Geysering was a very infrequent occurrence, considering the numbers of tractors in service. Whether it would occur was determined by a number of factors, including engine heat, agitation of fuel in the tank, ambient air temperature, and wind direction and velocity. I.D.F. 50.

Harvester in fact took a number of steps of gradually increasing efficacy over the next twenty years. As early as 1958 it had mailed a "Service Slant"—an internal memorandum for its [9] dealers—that described the problem.[9] This warning went only to the Harvester dealers, who generally do not pass such bulletins on to their customers.[10] Nothing in the record suggests that this particular warning ever actually reached the tractor operators.[11] In 1963 Harvester revised its operator's manuals to include a warning against removal of the gas cap from a hot or running tractor. This warning was incomplete in a number of respects, however. It was included only in the manuals for new tractors, leaving the manuals for the more numerous older models unrevised, and it did not specifically mention fuel geysering as a possible consequence of cap removal, thus leading readers to attach less significance to the warning than they would otherwise have done. I.D.F. 151. In 1976 Harvester produced a new fuel tank decal which repeated the warning against removing the cap from a hot tractor, and added an injunction to [10] tighten the cap securely.[12] This was perhaps the most effective warning yet, but it had a very limited distribution. Only 980 gasoline-powered tractors were produced after 1975—because the industry was switching to diesel fuel—and the decals reached the older tractors only on an irregular basis. I.D.F. 164. Moreover, this decal again failed to spell out the exact nature of the hazard at a level of detail that would effectively motivate compliance.

In 1979 Harvester began work on the warning program that all parties agree was finally effective. This was the Fuel Fire Prevention Program. It was an initiative of the Product Integrity Group, an organization within the company that had responsibility for studying safety problems. The centerpiece of the program was a direct mailing made to some 630,000 Harvester customers in August, 1980. This mailing explicitly warned about the existence of fuel geysering: "[The] sudden eruption of gasoline exposes the operator to, and may cover him with, liquid fuel and vapors and is a clear fire hazard if a source of ignition is present. . . ." CX 375; I.D.F. 201-02. Coupled with this warning was an announcement that Harvester was [11] providing, free of charge, a new gas cap that would prevent geysering. I.D.F. 203. The ALJ found that the 1980 warning was complete and was effectively distributed to the people in need of the information. He therefore concluded that Harverster's duties to its customers was discharged as of that date. I.D.F. 261.

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[9] The Service Slant contained the following warning:

> The hiss of escaping vapor from filler cap vents is an indication of pressure buildup in the tractor fuel tank; removal of the filler cap should not be attempted until the pressure has dropped and the tractor cooled down. A quick release of pressure from the tractor fuel tank by the operator's removal of filler cap will result in a temporary effervescence of fuel, this in the presence of a hot engine or other means of ignition can be a fire hazard.

Service Slant #24–58, May 1958; CX35; RX22 *See* I.D.F. 144. Although the word "effervescence" may not be the best description of fuel geysering, this warning might still have been adequate if it had been properly distributed.

[10] I.D.F. 142.

[11] I.D.F. 154.

[12] I.D.F. 164–65. The text of the decal read as follows:

> AVOID FIRES. TIGHTEN cap securely. Do not open when engine is RUNNING or HOT.

In the same year a parallel change was made in the operator's manual, calling greater attention to the old 1963 warning through more prominent symbols and more conspicuous type, and adding the caution about tightening the cap. Still, however, these warnings did not reach the operators of older tractors, and did not describe the specific risks of fuel geysering.

II. APPLICABLE LEGAL STANDARDS

The above facts are, as we have said, not seriously in dispute. The principal issues in this case instead revolve around the proper legal construction that should be placed on the facts. In this section of the opinion we will review, in general terms, the legal standards applicable to the case. In the following section we will bring the facts and the law together in an analysis of the ultimate issues of liability.

The basic law of this case is Section 5 of the FTC Act. That section states that "unfair or deceptive acts or practices . . . are declared unlawful."[13] The Administrative Law Judge found violations of both parts of the statute. He concluded that Harvester's failure to warn about the hazards of fuel geysering was a form of deception, a failure to dispel an incorrect belief among consumers that the tractors would be fit for their ordinary [12] use.[14] He also found that the failure to warn was unfair, since it subjected consumers to a risk of harm that they could not reasonably have avoided, but that Harvester could have prevented at relatively small cost.[15] We will discuss these two charges in sequence.

Deception

The first charge considered in this case was deception. "Deception" is specifically prohibited by the FTC Act, and the Commission has had particular experience over the years in applying this concept. In most deception cases injury comes about when consumers are led to purchase a product that they would not otherwise have selected. In such cases the Commission's deception jurisdiction acts to safeguard the exercise of consumer sovereignty.[16] Consumers may also incur injury through choices relating to their post-purchase conduct, however, such as decisions on the care and use of the product. [13] These decisions may likewise be protected by the Commission's deception jurisidiction.[17]

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[13] 15 U.S.C. 45(a)(1).

[14] I.D. 99-100, 107.

[15] I.D. 100-04, 107. The ALJ also found that the practices constituted an unfair method of competition. Because of our resolution of other issues in this case we do not need to address that question.

Our approach to deception cases was described in a policy statement that the Commission issued in 1983.[18] That document explains how the Commission reads its precedents and thus how it will apply that body of law. In brief, a deception case requires a showing of three elements: (1) there must be a representation, practice, or omission likely to mislead consumers; (2) the consumers must be interpreting the message reasonably under the circumstances; and (3) the misleading effects must be "material," that is, likely to affect consumers' conduct or decision with regard to a product. Our deception analysis thus focuses on risk of consumer harm, and actual injury need not be shown.[19]

Deception is a particularly troublesome form of conduct. It is harmful to consumers, undermines the rational functioning of the marketplace, and, unlike some other practices we are called upon to review, never offers increased efficiency or other countervailing benefits that must be considered. In view of [14] deception's unalloyed negative qualities, the three elements of the deception analysis represent streamlined procedures adopted by the Commission to deal most effectively with such practices.

The first element in the analysis states that there must be a representation, practice, or omission that is likely to mislead the consumer. The essence of deception is its misleading effects, and we therefore require some evidence that this undesirable consequence is indeed likely to come about. However, as one instance of streamlining, we do not go beyond likelihood to require evidence on the incidence of actual false belief.[20]

The second element states that consumers must be interpreting the advertisement reasonably under the circumstances.[21] A company cannot be liable for every possible reading of its claims, no matter how far-fetched. We therefore require that the consumer interpretation in any particular case be reasonable. The Commission, however, will not require evidence that a claim has been interpreted in a certain way by [15] some threshold number of consumers. Consumers acting reasonably under the circumstances are those who have acted in a way consistent with the broad range of ordinary or average people.[22]

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[16] The touchstone here is free consumer choice. We do not look for evidence that the product selected is actually inferior to its alternatives.

[17] The underlying theory is that the care-and-use requirement of a product, if known by consumers, will affect their initial purchase decisions.

[18] Letter from Federal Trade Commission to Congressman Dingell (Oct. 14, 1983) (hereinafter cited as Deception Statement). This letter is reproduced as an Appendix to our opinion in *Cliffdale Associates, Inc.*, Docket No. 9156 (FTC March 23, 1984) [103 F.T.C. 110].

[19] *See* Deception Statement, p.16 (if inaccurate or omitted information is material, consumer injury is likely and a corrective FTC action is appropriate).

[20] In some circumstances evidence on this point may be necessary, but it is not an element in the generic offense of deception.

[21] *See* Deception Statement, p.7. This element focuses only on the interpretation of a claim. We do not inquire further and consider the reasonableness of the consumer's decision to accept or believe in a particular claim. Thus, an express claim for a baldness cure would be interpreted by a reasonable consumer as meaning what it said, and we would not inquire into the consumer's reasonableness in relying on such claims.

Finally, the third element in a deception case states that the misleading effects must be material. A material effect is one which is likely to influence a consumer's conduct or purchase decision. We therefore require that the seller's conduct be likely to distort the ultimate exercise of consumer choice. The Commission, however, presumes that all express claims are material,[23] and that implied claims are material if they pertain to the central characteristics of the product, such as its safety, cost, or fitness for the purpose sold.[24] Our reasoning here is that the seller is in the best position to assess the effects of his ads, and if he finds it beneficial to make such claims it must be because they are likely to have an influence on consumers. We therefore conclude that claims on these particular topics are likely to affect consumer choice. If the claims are also false, moreover, we can make the further presumption that prohibiting them will cause a net increase in consumer welfare, without the need for us to engage in our own detailed inquiry into the costs and benefits of various courses. [16]

In short, the deception case addresses an especially harmful form of behavior, and so it embodies a number of expediting and simplifying elements in order to do so most effectively.

Actionable deception theory is not limited to false or misleading statements. Under two general circumstances it can also reach omissions. First, it can be deceptive to tell only half the truth, and to omit the rest. This may occur where a seller fails to disclose qualifying information necessary to prevent one of his affirmative statements from creating a misleading impression.[25] The Commission has brought a number of cases on this theory. It has challenged "Geritol" advertising for claiming that the product can reduce tiredness while failing to disclose that in most cases those symptoms are caused by factors other than a lack of the vitamins and iron that the medicine contains;[26] it has challenged the advertising of baldness cures for failing to disclose that most baldness results [17] from male heredity and cannot be treated;[27] and it has challenged claims that a product can produce weight losses of a certain amount while failing to disclose that losses of this magnitude, rather than being typical, are extremely rare.[28]

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[22] This range applies to any relevant quality, such as intelligence, experience, or credulity. If the representations or sales practices are targeted to a specific audience, then reasonable consumers are representative members of that group.

[23] Deception Statement, p.16.

[24] Deception Statement, p.2 n.4, p.17.

[25] *Cf. P. Lorillard Co. v. FTC*, 186 F.2d 52, 58 (4th Cir. 1950) ("to tell less than the whole truth is a well known method of deception").

It can also be deceptive for a seller to simply remain silent, if he does so under circumstances that constitute an implied but false representation. Such implied representations may take any of several forms. They may arise from the physical appearance of the product, or from the circumstances of a specific transaction, or they may be based on ordinary consumer expectations as to the irreducible minimum performance standards of a particular class of good.[29] The Commission has brought several cases on this theory. It has upheld charges against sellers who failed to disclose that an apparently new product was [18] actually used,[30] that a simulated-wood product was actually made of paper,[31] that a sales contract would be sold to a holder in due course,[32] that land sold for investment purposes was poorly suited to that use due to its remote location,[33] and that a book was an abridged rather than a complete edition.[34] One generalization that emerges from these cases is that by the very act of offering goods for sale the seller impliedly represents [19] that they are reasonably fit for their intended uses.[35] The concept of reasonable fitness includes a further implied representation that the products are free of gross safety hazards,[36] although not necessarily of all or relatively improbable dangers.

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[26] *J.B. Williams Co. v. FTC*, 381 F.2d 884, 890 (6th Cir. 1967).

[27] *Ward Laboratories v. FTC*, 276 F.2d 952 (2nd Cir.), *cert. denied*, 364 U.S. 827 (1960); *Keele Hair & Scalp Specialists*, 55 F.T.C. 1840 (1959), *aff'd*, 275 F.2d 18 (5th Cir. 1960).

[28] *Porter & Dietsch v. FTC*, 605 F.2d 294, 303 (7th Cir. 1979), *cert. denied*, 445 U.S. 950 (1980). A second half-truth in this case involved the claim that the product contained "no dangerous drugs," since its active ingredients could be hazardous to people with certain preexisting conditions such as diabetes and high blood pressure.

[29] For example, consumers presumably assume that any automobile is capable of going at least 55 miles per hour, and they evaluate the product's price on the basis of that assumption. If someone devised a new economy car that had a top speed of only 35 miles per hour, he would have to disclose that fact or else be guilty of a deceptive omission.

[30] *Olson Radio Corp.*, 30 F.T.C. 1758 (1962) (television tubes rebuilt containing used parts); *cf. Peacock Buick, Inc.*, 86 F.T.C. 1532, 1557 (1975), *aff'd* 553 F.2d 97 (4th Cir. 1977) (automobile dealer failed to disclose extent to which cars being sold as "late models" had been previously used for driver education or as rental cars).

[31] *Haskelite Mfg. Corp.*, 33 F.T.C. 1212, 1216 (1941), *aff'd*, 127 F.2d 765 (7th Cir. 1942)

[32] *All-State Industries of North Carolina, Inc.*, 75 F.T.C. 465, 490 (1969), *aff'd* 423 F.2d 423 (4th Cir.), *cert. denied*, 400 U.S. 828 (1970); *Southern States Distributing Co.*, 83 F.T.C. 1126, 1172–73 (1973); *Certified Building Products, Inc.*, 83 F.T.C. 1004 (1973).

[33] *Horizon Corp.*, 97 F.T.C. 464 (1981).

[34] *Bantam Books, Inc.*, 55 F.T.C. 779 (1958); *New American Library of World Literature, Inc.*, 49 F.T.C. 760, 766 (1953) ("in the absence of a clear and conspicuous disclosure of the fact of abridgement or change of title, the offering of an abridged book or of an old book under a new title unquestionably [may] deceive").

[35] This point was made in the Deception Statement:

> In determining whether an omission is deceptive the Commission will examine the overall impression created by a practice, claim, or representation. For example, the practice of offering a product for sale creates an implied representation that it is fit for the purposes for which it is sold.

Deception Statement, p.2 n.4. This point is also similar to the implied warranty of merchantability in the Uniform Commercial Code. *See* U.C.C. Section 2–314(2). For a general discussion see III R. Anderson, The Uniform Commercial Code Sections 314:29 –:30 (1983).

Not all omissions are unlawfully deceptive under Section 5. Such is the case with what is sometimes characterized as a "pure omission." This is a subject upon which the seller has simply said nothing, in circumstances that do not give any particular meaning to his silence. Like any other form of omission, pure omissions may lead to erroneous consumer beliefs if consumer had a false, pre-existing conception which the seller failed to correct.

The Commission does not treat pure omissions as deceptive, however.[37] There are two reasons for this. First, we could not declare pure omissions to be deceptive without expanding that [20] concept virtually beyond limits. Individual consumers may have erroneous preconceptions about issues as diverse as the entire range of human error, and it would be both impractical and very costly to require corrective information on all such points.[38] Second, pure omissions do not presumptively or generally reflect a deliberate act on the part of the seller,[39] and so we have no [21] basis for concluding, without further analysis, that an order requiring corrective disclosure would necessarily engender positive net benefits for consumers or be in the public interest.

If we were to ignore this last consideration, and were to proceed under a deception theory without a cost-benefit analysis, it would surely lead to perverse outcomes. The number of facts that may be material to consumers—and on which they may have prior misconceptions—is literally infinite. Consumers may wish to know about the life expectancy of clothes, or the sodium content of canned beans, or the canner's policy on trade with Chile. Since the seller will have no way of knowing in advance which disclosure is important to any particular consumer, he will have to make complete disclosures to all. A television ad would be completely buried under such disclaimers, and even a full-page newspaper ad would hardly be sufficient for the purpose. For example, there are literally dozens of ways in which one can be injured while riding a tractor, not all of them obvious before the fact, and under a simple deception analysis these would [22] presumably all require affirmative disclosure. The resulting costs and burden on advertising communication would very possibly represent a net harm for consumers.[40]

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[36] *Cf. Nuclear Products Co.*, 49 F.T.C. 229 (1952) (product containing toxic materials).

[37] As a historical matter, we are aware of few if any cases involving pure omissions as we are using that term. *See* notes 38 & 53, *infra*.

[38] This holding is consistent with the position that we took in the Cigarette Rule. There we stated that it could be deceptive to fail to disclose the health hazards of smoking. This decision was based, however, not so much on theories of omission as on the perceived presence of half-truths and implied misrepresentations in cigarette advertising, which pictorially depicted smoking as pleasant and healthful without also giving information on its associated health risks. *See* Statement of Basis and Purpose, Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, 29 FR 8324, 8356 (1964). The Cigarette Rule thus does not stand as a precedent for a challenge to pure omissions. While in the Statement of Basis and Purpose for that rule we referred to formal proceedings that the Commission has brought "in the area of 'pure' failure to disclose," *see* id. at 8352, it is clear from the context that this reference to "pure" omissions was intended only to identify a general class of cases in which no express affirmative representation had been made. The term did not refer to pure omissions as we have defined that term in text. Rather, the Commission meant something more nearly akin to implied misrepresentations:

> The nature, appearance, or intended use of a product may create an impression in the mind of the consumer—for example, that it is made in the U.S.A., or that it is silk, or that it is safe—and if the impression is false, and if the seller does not take adequate steps to correct it, he is responsible for an unlawful deception.

Id. We therefore conclude that the Cigarette Rule did not reflect a policy of prosecuting pure omissions as we have used that term.

[39] Although deception law permits such presumptions, it does not, of course, require any showing of actual intent on the part of the seller. *See Chrysler Corp. v. FTC*, 561 F.2d 357, 363 & n.5 (D.C. Cir. 1977); *Feil v. FTC*, 285 F.2d 879, 896 (9th Cir. 1960).

Although pure omissions are not appropriately characterized as deceptive or reached through deception analysis, however, they may nonetheless cause significant consumer injury. In that event they might still be reached as unfair. It is to that part of our jurisdiction that we now turn.

Unfairness

The Commission's unfairness jurisdiction provides a more general basis for action against acts or practices which cause significant consumer injury. This part of our jurisdiction is broader than that involving deception, and the standards for its exercise are correspondingly more stringent. It requires the complete analysis of a practice which may be harmful to consumers. To put the point another way, unfairness is the set of general principles of which deception is a particularly well-established and streamlined subset. [23]

Over the past four years the Commission has devoted considerable attention to clarifying these general principles. In 1980 we prepared a formal policy statement describing our jurisdiction over unfair practices.[41] The statement took as its point of departure the familiar language of the *Sperry & Hutchinson* case.[42] It declared that most

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[40] Nor could we avoid this result by simply trusting in the Commission's discretion not to bring cases that would be unreasonably burdensome. There are three drawbacks to that approach. First, it gives no guidance to future Commissions. Second, it gives no comfort to the seller who is endeavoring to comply with the law, since he cannot tell how the Commission will exercise its discretion and so he must still make disclosures to meet any eventuality. And third, the discretion standard, when properly applied, is not really a different test from the one we have adopted. In exercising sound discretion the Commission *must* be weighing the costs and benefits of a proposed action. This is true virtually by definition. In such a case, therefore, there is no reason not to acknowledge what we are doing and to formally adopt a cost-benefit standard.

[41] The statement was included as part of a letter from the Federal Trade Commission to Senators Ford and Danforth (Dec. 17, 1980) (hereinafter cited as "Unfairness Statement"). A copy of the statement is attached as an Appendix to this opinion.

[42] *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233 (1972). There the Supreme Court recited in a footnote, with apparent approval, the three criteria of unfairness that the Commission traditionally applied:

> (1) whether the policy, without necessarily having been previously considered unlawful, offends public policy as it has been established by statutes, the common law, or otherwise—whether, in other words, it is within at least the penumbra of some common-law, statutory, or other established concept of unfairness: (2) whether it is immoral, unethical, oppressive, or unscrupulous; (3) whether it causes substantial injury to consumers (or competitors or other businessmen).

(footnote cont'd)

unfairness cases would be brought under the consumer injury theory identified in that decision.[43] It also systematized the essential elements of that theory. An actionable consumer injury must be: (1) substantial; **[24]** (2) not outweighed by any offsetting consumer or competitive benefits that the practice produces; and (3) one which consumers could not reasonably have avoided.[44]

The first element to this analysis is that the injury must be substantial. Unlike deception, which focuses on "likely" injury, unfairness cases usually involve actual and completed harms. While in most cases the harm involved is monetary, the policy statement expressly noted the "unwarranted health and safety risks may also support a finding of unfairness."[45]

The second element is that the conduct must be harmful in its net effects. This is simply a recognition of the fact that most conduct creates a mixture of both beneficial and adverse consequences. In analyzing an omission this part of the unfairness analysis requires us to balance gainst the risks of injury the costs of notification and the costs of determining what the prevailing consumer misconceptions actually are. This inquiry must be made in a level of detail that deception analysis does not contemplate. **[25]**

Finally, the third element is that the injury be one that consumers could not reasonably have avoided through the exercise of consumer choice.[46] This restriction is necessary in order to keep the FTC Act focused on the economic issues that are its proper concern. The Commission does not ordinarily seek to mandate specific conduct or specific social outcomes, but rather seeks to ensure simply that markets operate freely, so that consumers can make their own decisions.[47]

To accomplish these goals the Commission may require that consumers be given the information that is critical to an informed

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405 U.S. at 244–45 n.5, *quoting* the Commission's position in the Cigarette Rule, Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, Statement of Basis and Purpose, 29 FR 8324, 8355 (1964).

[43] The other two *S&H* theories were of lesser importance. The Unfairness Statement declared that the public policy theory would henceforth be used primarily to cross-check and confirm a finding of consumer injury. The theory of immoral or unscrupulous conduct was abandoned altogether, so that henceforth it would not serve as an independent basis of liability.

[44] Unfairness Statement, pp.5–7.

[45] Unfairness Statement, p.6, citing to *Philip Morris, Inc.*, 82 F.T.C. 16 (1973) (respondent had distributed free-sample razor blades in such a way that they could come into the hands of small children) (consent decree). As the reference to "risks" in this quotation makes clear, unfairness cases may also be brought on the basis of likely rather than actual injury, although this is not the usual practice.

[46] As with deception, most unfairness cases are brought to protect the exercise of consumer choice in the initial purchase decision, but such cases can also protect choices with respect to the post-purchase care and use of a product.

[47] Some commentators have interpreted our policy statement as involving essentially a general balancing of interests, with all the imprecision of that course, rather than a definable economic rule. In fact, however, the principal focus of our unfairness policy is on the maintenance of consumer choice or consumer sovereignty, an economic concept that permits relatively specific identification of conduct harmful to that objective. *See* Averitt, *The Meaning of "Unfair Acts or Practices in Section 5 of the Federal Trade Commission Act,"* 70 Geo. L.J. 225 (1981).

choice.[48] There is also a need for principled limits on this concept, of course, since virtually any piece of information may be useful to some consumers. While this balance must ultimately be struck in the context of the individual case, the Commission has decided on certain general principles. In most **[26]** cases it is appropriate to limit mandatory disclosure to those core aspects of a transaction that virtually all consumers would consider essential to an informed decision.[49] These are the same basic characteristics discussed above in connection with common-law merchantability: (1) information bearing on fitness for intended use, and (2) information bearing on significant hidden safety hazards.

These characteristics are applied here in a slightly different way, however. In an assessment of deceptive omissions we are applying a relatively streamlined set of principles and so we must be careful not to go too far and infer warranties too freely about relatively improbable safety hazards. We therefore take a relatively cautious view of the information that must be disclosed under that theory. In an assessment of unfairness, on the other hand, we conduct a full cost-benefit analysis, in which we weigh the consumer benefits of disclosure against their likely costs, and so there is less risk of an overbroad result. We can therefore take a more inclusive view of the information that must be disclosed under this approach. **[27]**

In short, an omission may be found unfair even though it is not deceptive. To do so, however, requires a more thorough analysis than is used in deception cases.

III. ANALYSIS OF THE CASE

In this section we will apply our general legal theory to the specific facts of the case. Since the analytical elements of deception and unfairness differ in so many particulars, we will again consider those two approaches separately.

Deception

As discussed above, the omission of information about a product may be deceptive under certain circumstances. In the present case the seller's silence is said to have led to an implied warranty that the tractor was fit for its intended use, when it in fact was not.

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[48] Ordinarily information disclosure is handled by market forces, of course. Sometimes, however, a market failure occurs, as when the balance between the risk of tort losses and the risk of lost sales produces significant disincentives to disclosure, or when the costs of non-disclosure become hard to quantify, as in certain safety issues. Corrective FTC action would then be appropriate.

[49] There are many precedents for the principle that mandatory disclosures should be limited, even though some wider range of information may still be material. Information about credit terms is presumably material to most consumers, for example. Credit information is nonetheless not required to be disclosed as a general matter, but only if certain "triggering" claims have first been made. *See generally* Truth in Lending Act, 15 U.S.C. 1601 *et seq. See also* Proprietary Vocational and Home Study Schools, 16 C.F.R. 438 (school's placement rate must be disclosed but only if employment or earnings claims are made), *rule set aside on other grounds, Katherine Gibbs School (Inc.) v. FTC,* 612 F.2d 658 (2nd Cir. 1979).

We believe that this charge cannot be sustained, however. The implied warranty of fitness is not violated by all undisclosed safety problems. The critical issue is the degree of risk involved.[50] Where the risk of mishap is very small it cannot be said that the product is unfit for normal use. Such a **[28]** case could therefore not satisfy the first element of the deception test, which requires the showing of a misleading representation. It would therefore not be appropriately analyzed under the law against deception.

Harvester manufactured approximately 1.3 million gasoline-powered tractors in the period after 1939. Of this number, twelve are known to have been involved in geysering accidents involving bodily injury. This is an accident rate of less than .001 percent, over a period of more than 40 years. Since the state of maintenance was shown to have some effect on a tractor's susceptability to fuel geysering, moreover, the rate for tractors in a good state of repair is likely to have been even less than this. Reflecting the low accident rate, one government study of tractor accidents did not even list fuel geysering as one of the tabulated kinds of mishaps, but simply lumped it into the residual category of "all other causes."[51]

This relatively low level of danger does not mean that the use of Harvester tractors is inherently unreasonable or imprudent. This case therefore does not involve a breach of the implied warranty of fitness, and so does not involve the element of deception.[52] **[29]**

We do not mean to imply by this that the accident rate for Harvester tractors was inconsequential, or that persons who are injured in relatively rare kinds of mishaps do not deserve legal protection. Quite the contrary, such persons may well be entitled to a remedy under other portions of the FTC Act. We merely hold here that such close cases should not be pursued without undertaking a cost-benefit analysis, and that they therefore do not qualify for the streamlined legal procedures of a deception action.[53] **[30]**

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[50] To put this point another way, a seller impliedly warrants only that a product is *reasonably* safe, not that it is free of all hazards. We recognize that there is no such thing as a totally safe product, and especially not when dealing with relatively complex machinery.

[51] *See* DOT Report, RX 32; I.D. 105. Also reflecting the improbability of a fuel geyser, Harvester's own engineers and testers, who might be expected to be most sensitive to such dangers, *themselves* commonly removed the gas caps during the course of tests. I.D. 99; I.D.F. 151.

[52] The dissenting opinion takes issue with our use of accident rates in this analysis, claiming that such an approach implies a tacit requirement that the staff show actual injury rather than merely risk of harm, and further suggesting that the approach amounts to an *ex post* review of events rather than being, as it should be, a before-the-fact assessment of the risks to which consumers may be subjected. These objections misinterpret the role of statistical evidence in cases such as this. The ultimate question at issue is, indeed, risk. What is the risk of consumer harm? If we have no actual experience with a particular problem we will endeavor to assess this risk from the most probative indirect evidence that is available. Where we have a statistically significant body of experience to draw upon, however, as we surely do here with 40 years' experience and hundreds of thousands of tractors, then the empirical incidence of harm, in the form of accident rates, is the best available measure of risk. To suggest, as the dissent does, that there is also some other kind of risk which is separate from this statistical risk, amounts really to no more than a conversational use of the term in the sense of "at risk." In this sense everyone is "at risk" at every moment, with respect to every danger which may possibly occur. When divorced from any measure of the probability of occurrence, however, such a concept cannot lead to useable rules of liability.

Unfairness

This brings us to unfairness as an alternative approach. The unfairness theory, it will be recalled, is the Commission's general law of consumer protection, for which deception is one specific but particularly important application. Unfairness calls for a somewhat more detailed analysis of a challenged practice. This focuses on three criteria: (1) whether the practice creates a serious consumer injury; (2) whether this injury exceeds any offsetting consumer benefits; and (3) whether the injury was one that consumers could not reasonably have avoided. We find that all three criteria are satisfied in the present case.

There clearly has been serious consumer injury. At least one person has been killed and eleven others burned. I.D.F. 27. Many of the burn injuries have been major ones, moreover, resulting in mobility limitations, lasting psychological harm, and severe disfigurement. I.D.F. 28 & n.2. These injuries are of a kind that satisfies the first unfairness test. It is true that they involve physical rather than economic injury, but the Unfairness Statement reaches such matters.[54] It is also true that they involve only limited numbers of people, but the **[31]** Statement provides that conduct causing a very severe harm to a small number will be covered as well.[55] A number of previous Commission cases have in fact been brought to correct injuries less numerous and less severe than those involved here.[56]

The second criterion states the consumer injury must not be outweighed by any countervailing benefits to consumers or to competition that the practice also brings about. This inquiry is particularly important in the case of pure omissions. Since the range of such omissions is potentially infinite, the range of cost-benefit ratios from actions to force disclosure is infinite as well, raising the possibility that a particular action may be ill-advised. We believe that this criterion is also satisfied in the present case, however. The consuming public has realized no benefit from Harvester's non-disclosure that is at all sufficient to offset the human injuries involved.[57] **[32]**

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[53] There are, it is true, a number of prior Commission decisions that have found deception on the basis of facts generally similar to those involved here. In *Stupell Enterprises* the respondent was found guilty of deception for failing to disclose that a toy could break in a way that could cause serious eye injury. *Stupell Enterprises, Inc.*, 67 F.T.C. 173, 187 (1965). In *Seymour Dress* and *Academy Knitted Fabrics* the Commission found it deceptive for a manufacturer to fail to disclose that clothes made from a brushed rayon fabric were highly flammable. *Seymour Dress & Blouse Co.*, 49 F.T.C. 1278, 1282 (1953) (decision of hearing examiner, which became decision of the Commission); *Academy Knitted Fabrics Corp.*, 49 F.T.C. 697, 701 (1952) (same). All three matters involved the non-disclosure of a safety risk that was quite improbable but also quite serious if it did come about. These are cases from the 1950's and early 1960's, however. They date from a time when unfairness law was very poorly developed, and when, for the most part, a case had to be described in terms of deception if it was to be brought within the FTC Act at all. Without in any way questioning the substantive outcome of those cases, therefore, we suggest that if they were brought today they would be brought under an unfairness theory.

[54] Unfairness Statement, p.6.

[55] *Id.*, p.5 n.12 ("An injury may be sufficiently substantial, however, if it does a small harm to a large number of people, or if it raises a significant risk of concrete harm").

[56] In *Stupell* there was evidently evidence of only three eye injuries from use of the toy. *Stupell Enterprices, Inc.*, 67 F.T.C. 173, 185 (1965). *See also Uncle Ben's, Inc.*, 89 F.T.C. 131, 136 (1977) (consent decree) (FTC banned television ad showing child cooking food without adult supervision because this might lead children to imitate this potentially harmful activity); *Philip Morris, Inc.*, 82 F.T.C. 16 (1973) (consent decree) (respondent had distributed free-sample razor blades in a way that might reach small children).

The principal tradeoff to be considered in this analysis is that involving compliance costs. More information may generally be helpful to consumers, but all such information can be produced only by incurring costs that are ultimately born as higher prices by those same consumers.[58] One must determine the level of preexisting customer knowledge, ascertain the actual facts on a particular issue, and communicate those facts effectively to the affected customers. Such activities are not always cheap. Harvester's Fuel Fire Prevention Program, for example, which finally led to an effective warning, involved both media advertisements and a direct mailing to 630,000 tractor operators, and cost the company approximately $2.8 million. I.D.F. 205, 224, 181. The costs of monitoring and experimentation undertaken in previous years undoubtedly raise the final figure even higher than this. The Commission should not impose costs of such magnitude without first comparing them with the benefits to be expected.

Here, however, we have no doubt that such a calculation favors disclosure. Harvester's expenses were not large in relation to the injuries that could have been avoided. Nor do we mean to rule out the possibility that some other, less expensive form of notification—such as a clearly worded warning in the **[33]** operating manual—would also have been sufficient.[59] We therefore conclude that the costs and benefits in this case satisfy the second unfairness criterion.

Finally, the third unfairness criterion states that the injury must be one that consumers could not reasonably have avoided. Here tractor operators could in fact have avoided their injuries by following a few relatively simple safety rules. If they had refrained from removing the cap from a hot or running tractor—something that both the owner's manuals and common knowledge suggested was a dangerous practice[60]—fuel geysering would have been completely precluded.

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[57] Whenever an omission results in serious bodily injury it is, of course, especially likely that a cost-benefit analysis will favor disclosure.

[58] Other, non-monetary costs may also be incurred. For example, if the Commission requires disclosure of one fact a seller may be less inclined to volunteer other facts, resulting in a net diminution of information.

[59] In making these calculations we do not strive for an unrealistic degree of precision, valuing an injury or a life at precisely x many dollars. We assess the matter in a more general way, giving consumers the benefit of the doubt in close issues. This course follows from the Commission's long tradition of giving especial care to issues involving physical safety. *See, e.g., Firestone Tire & Rubber Co.,* 81 F.T.C. 398, 451, 456 (1972). What is important, however, is that we retain an overall sense of the relationship between costs and benefits. We would not want to impose compliance costs of millions of dollars in order to prevent a bruised elbow.

[60] We assume for purposes of this discussion that the warnings in the owner's manuals actually reached the affected operators. As discussed above, however, this was not necessarily the case.

Harvester therefore argues that one necessary element of unfairness is not present.

Upon full consideration, however, we believe that this element is satisfied as well. The issue here is whether the safety rules for these tractors were adequately disclosed. Whether some consequence is "reasonably avoidable" depends, not just on whether people know the physical steps to take in order to prevent it, but also on whether they understand the necessity **[34]** of actually taking those steps. We do not believe that this need was fully appreciated here. Farmers may have known that loosening the fuel cap was generally a poor practice, but they did not know from the limited disclosures made, nor could they be expected to know from prior experience, the full consequences that might follow from it. This is therefore not a situation in which the farmers themselves are primarily responsible for their own accidents.

The record contains much testimony suggesting that the victims of the phenomenon did not realize that a fuel geyser was possible. One farmer stated that he had removed gas caps "many, many" times in order to check on fuel level, without having had gas spew out of the filler neck.[61] Another states that: "Not in my wildest imagination had I thought that could happen."[62] Still another explained that he regularly loosened the cap to relieve pressure-related hissing noises:

> It [the hissing] happened a few times a day, two or three or four times a day. It just kind of—it is something you didn't feel like you wanted to keep driving. That noise kind of hissing at you. So you just leaned ahead and loosened the gas cap a little bit. The air would come out and that would be all there would be to it. There would be a puff of air and it would quit.[63] **[35]**

In short, loosening the fuel cap was something that farmers did on many occasions, without consciousness of any particular risk, beyond the presumably obvious requirement of having to keep open flame away from the filler neck, which they felt quite able to do.

Since fuel geysering was a risk that they were not aware of, they could not reasonably have avoided it. This is so even though they had been informed of measures to prevent it. Such information was not the same thing as an effective warning:

> [I]mplicit in the duty to warn is the duty to warn with a degree of intensity that would cause a reasonable man to exercise for his own safety the caution commensurate with the potential danger.[64]

Such a warning was not provided in this case. We therefore find that the three elements of unfair conduct are present, and that Harvester's non-disclosures violated Section 5 of the FTC Act.

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[61] Greathouse, Tr. 206-07, referring to his experience on older John Deere tractors.

[62] Cameron, Tr. 410.

[63] Clowes, Tr. 1836. On a later occasion Clowes was involved in a fuel geysering incident.

[64] *Tampa Drug Co. v. Wait*, 103 So.2d 603, 609 (Fla. 1958).

IV. JURISDICTIONAL AND PROCEDURAL ISSUES

In addition to the principal substantive questions in this case, Harvester has raised on appeal a number of collateral procedural issues. These go to the Commission's jurisdiction or to the appropriateness of an enforcement action under the present circumstances. More specifically, Harvester has suggested that: (1) this proceeding is moot; (2) the FTC Act, as construed **[36]** by the Commission, constitutes an excessive delegation of legislative power; and (3) the firm in any case has not been engaged in interstate commerce with respect to the challenged conduct. We will review these three contentions in sequence.

Harvester first suggests that this proceeding is moot. In support of this contention they point out that the firm made a fully adequate disclosure of the safety problems in 1980, and has converted from gasoline to diesel power, thus ensuring that the previous problems of non-disclosure cannot recur.[65] These arguments are insufficient to establish mootness, however. At most they show that the specific facts alleged here—non-disclosure of fuel geysering in gasoline-powered tractors—are unlikely to arise again. They do not show that Harvester may not return to the general course of conduct with which it is charged, namely, failing to disclose known safety hazards. In this case the complaint counsel is seeking a broad order against non-disclosure of hazards on any and all types of Harvester farm equipment. The developments that Harvester points to have therefore not given complaint counsel everything that he might win through litigation, and the case is therefore not moot.[66] **[37]**

Harvester next suggests that Section 5 of the FTC Act is an excessive delegation of congressional authority. Harvester is particularly troubled by the use of this authority to impose continuing duties of disclosure on a manufacturer with respect to relatively old products, and, more generally, by the asserted lack of clear standards under this statute. Imposing a duty with respect to old products is not particularly troublesome, however, since an obligation should ordinarily extend as long as the risk of harm exists; and since geysering was also a hazard for new tractors; and since in any event much of the delay in bringing an action was due to Harvester's own previous non-disclosure. Nor is a statute which permits such results necessarily an example of excessive delegation. Section 5 has withstood repeated attack on delegation grounds,[67] and many courts have noted, without disapproval, that Congress deliberately drafted the statute in general terms in order to let the Commission deal with new practices as they emerged.[68] Even if there were to have been delegation problems, moreover, which we believe not to be the case, the Commission has since clarified the key provisions of **[38]** its statute with enough specificity to alleviate the issue. We have defined both unfairness and deception in separate policy statements, and have, through a number of opinions, including this one, drawn principled lines of demarcation between these concepts.[69]

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[65] RAB, pp. 8–12.

[66] *See Rubbermaid, Inc.*, 87 F.T.C. 676, 707 (1976). The Commission previously considered the mootness issue in our Order Affirming the Public Interest in Continuing this Litigation (October, 1981), and concluded that the case was not moot. We hereby reaffirm that determination.

Third, Harvester suggests that it is not in fact engaged in interstate commerce in any of the activities with which it is now charged. Harvester points out that it manufactured no gasoline-powered farm tractors since 1978, and very few since 1976, so that it was not engaged in substantial trade in these items for four years prior to issuance of the complaint. RAB 12–14. As the ALJ found, however, the firm does conduct some continuing business that involves gasoline tractors. It still supplies owner's manuals, spare parts, and accessories for its older gasoline models. I.D.F. 4. Harvester was also, of course, until two years before the complaint, in the business of manufacturing such tractors. *Id.* These facts are sufficient to satisfy the interstate-commerce requirement. It is well established that the **[39]** antitrust laws do not contain a statute of limitations, so that corrective action may be taken whenever it comes to appear that it would be beneficial, as is the case here when we may be able to prevent future injury to Harvester operators.[70] We are confirmed in this conclusion by the fact that the FTC Act was amended in 1975 to reach conduct "in *or affecting*" interstate commerce,[71] indicating a desire to extend the Commission's jurisdiction in this respect to the full limits of the Commerce Clause.

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[67] *See, e.g., National Harness Mfrs.' Ass'n. v. FTC,* 268 F. 705 (6th Cir. 1920); *Sears, Roebuck & Co. v. FTC,* 258 F. 307, 312 (7th Cir. 1919); *T.C. Hurst & Son v. FTC,* 268 F. 874 (E.D. Va. 1920).

[68] *See, e.g., Atlantic Refining Co. v. FTC,* 381 U.S. 357, 367 (1965); *FTC v. Standard Educ. Society,* 86 F.2d 692, 696 (2d Cir. 1936) (L. Hand, J.), *rev'd in part on other grounds,* 302 U.S. 112 (1937). As a matter of policy we believe that a greater degree of precision and predictability in the statute would be desirable. We therefore favor the use of guidelines or legislative clarification. This does not undermine the present constitutionality of the FTC Act, however.

[69] One underlying problem with the dissent is that it wishes to have conduct litigated simultaneously under the standards of both unfairness *and* deception. This, it seems to us, is unsound jurisprudence. Some overlap among the Commission's laws is no doubt inescapable, but this should be viewed as a necessary evil and minimized to the extent practical. Our objective should be to have clean, well-differentiated and well-understood legal principles, which can be readily understood and readily litigated. To the extent that we blur our unfairness and deception standards together we will only tend to confuse them both. Moreover, and contrary to the implication in the dissent, proceeding in this case under a single theory will not have the effect of leaving consumers unprotected. All necessary consumer remedies can be provided equally well under an unfairness theory as under a deception theory.

[70] *See United States v. E.I. duPont de Nemours & Co.,* 366 U.S. 316 (1961) (stock acquisition was challenged more than thirty years after the fact). *See also Simeon Management Corp.,* 87 F.T.C. 1184, 1222 (1976) (Initial Decision).

[71] Pub. L. 93–637, Section 201(a) (1975).

V. REMEDY

Finally, we have the issue of remedy. Having found that Harvester was engaged in unfair practices, we must now determine what corrective measures the public interest will require. This inquiry can be framed as a series of three questions. Should we issue a general order requiring disclosure of safety hazards in all of Harvester's agricultural equipment? Should we issue an order focused more narrowly on the facts of this particular case **[40]** and requiring disclosure of just the fuel geysering hazard? Or should we conclude that Harvester has already taken adequate corrective measures and therefore enter no order at all?

As a threshold matter we reject the option of an order covering all safety hazards on agricultural equipment. There would be formidable difficulties in defining "safety hazard" in a way precise enough to mean something other than a listing of all possible causes of accident. Moreover, we believe that all-products orders are most appropriate as a vehicle for "fencing in" violators when there is a particularly great risk of a recurrence of the illegal conduct.[72] Harvester's conduct does not lead us to such fears. Since 1972 the firm has been collecting information about farm accidents in order to identify emerging problems. I.D.F. 158. The law judge found that this system "should prove adequate for any future needs." I.D. 107. Harvester's response to information revealing the fuel-geysering problem, although not at first fully adequate, does suggest that the company will be basically responsible in its treatment of such matters. Harvester issued periodic warnings for twenty years, culminating in the Fuel Fire Prevention Program in 1980, which was an adequate disclosure. Significantly, the ALJ found, and we agree, that Harvester had committed itself to this program before learning of the Commission's interest in the issue. I.D.F. 308. We therefore believe that an all-products order against Harvester would not be justified. **[41]**

The obvious alternative is an order directed against the particular conduct discovered in this case. Here that would be an order requiring disclosure of the risks of fuel geysering. Such an approach is our ordinary and presumptive response to a finding of improper conduct. It is a response that we make even when the respondent has ceased engaging in the conduct in question, for we wish to ensure that he does not return to that conduct at such future time.[73]

Under the particular circumstances of this case, however, we will select a third option. That is to issue no order at all. Our reasons for doing so are twofold. First, Harvester's voluntary notification program has already provided all the relief that could be expected from a Commission order. Second, the changing technology of the tractor industry has obviated any concern that Harvester might return to its earlier violation. The industry has moved massively from gasoline to diesel power, thus eliminating concerns over issues relating to gasoline safety. Harvester has not made a gasoline tractor since 1978, and, as the ALJ found, "does not appear likely to do so again in the future." I.D. 105, *citing* I.D.F. 116. We therefore conclude that no order is necessary in the present case.[74] **[42]**

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[72] *Cf. United States v. W.T. Grant Co.*, 345 U.S. 629, 633 (1953).

[73] *See, e.g., Academy Knitted Fabrics Corp.*, 49 F.T.C. 697, 701 (1952) (decision of hearing examiner, which became decision of Commission) (order against the practice even though it had already been discontinued).

VI. CONCLUSION

This case is in most respects a routine dispute over the proper contours of consumer information disclosure. We have resolved that dispute by holding that disclosure was necessary here.

En route to that holding we also had to identify the proper legal framework to use when assessing pure omissions. We have decided that such omissions should be judged as cases of possible unfairness rather than of possible deception. Since pure omissions do not most probably reflect deliberate acts on the part of the sellers, we cannot be confident, without a cost-benefit analysis, that a Commission action would do more good than harm. Yet a cost-benefit analysis is required only under an unfairness and not under a deception approach. We will therefore treat these matters in unfairness terms in order to ensure that such an analysis is made. In so deciding we hope to have added something further to the clarity and rigor of our statute, so that decisions on the merits may henceforth be made and predicted with greater precision.

APPENDIX

FEDERAL TRADE COMMISSION
WASHINGTON, D. C. 20580

December 17, 1980

The Honorable Wendell H. Ford
Chairman, Consumer Subcommittee
Committee on Commerce, Science, and Transportation
Room 130 Russell Office Building
Washington, D.C. 20510

The Honorable John C. Danforth
Ranking Minority Member, Consumer Subcommittee
Committee on Commerce, Science and Transportation

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[74] A similar conclusion was recently reached by the Second Circuit. *See Borg-Warner Corp. v. FTC*, Docket No. 83-4207 (2d Cir., Oct. 3, 1984) (reversing Commission order in director-interlock case on grounds that, due to improbability of recurrence, no order was warranted).

Room 130 Russell Office Building
Washington, D.C. 20510

Dear Senators Ford and Danforth:

This is in response to your letter of June 13, 1980, concerning one aspect of this agency's jurisdiction over "unfair or deceptive acts or practices." You informed us that the Subcommittee was planning to hold oversight hearings on the concept of "unfairness" as it has been applied to consumer transactions. You further informed us that the views of other interested parties were solicited and compiled in a Committee Print earlier this year.[1] Your letter specifically requested the Commission's views on cases under Section 5 "not involving the content of advertising," and its views as to "whether the Commission's authority should be limited to regulating 'false or deceptive' commercial advertising." Our response addresses these and other questions related to the concept of consumer unfairness.

We are pleased to have this opportunity to discuss the future work of the agency. The subject that you have selected appears to be particularly timely. We recognize that the concept of consumer unfairness is one whose precise meaning is not immediately obvious, and also recognize that this uncertainty has been honestly troublesome for some businesses and some members of the legal profession. This result is understandable in [2] light of the general nature of the statutory standard. At the same time, though, we believe we can respond to legitimate concerns of business and the Bar by attempting to delineate in this letter a concrete framework for future application of the Commission's unfairness authority. We are aided in this process by the cumulative decisions of this agency and the federal courts, which, in our opinion, have brought added clarity to the law. Although the administrative and judicial evolution of the consumer unfairness concept has still left some necessary flexibility in the statute, it is possible to provide a reasonable working sense of the conduct that is covered.

In response to your inquiry we have therefore undertaken a review of the decided cases and rules and have synthesized from them the most important principles of general applicability. Rather than merely reciting the law, we have attempted to provide the Committee with a concrete indication of the manner in which the Commission has enforced, and will continue to enforce, its unfairness mandate. In so doing we intend to address the concerns that have been raised about the meaning of consumer unfairness, and thereby attempt to provide a greater sense of certainty about what the Commission would regard as an unfair act or practice under Section 5.

This letter thus delineates the Commission's views of the boundaries of its consumer unfairness jurisdiction and is subscribed to by each Commissioner. In addition, we are enclosing a companion Commission statement that discusses the ways in which this body of law differs from, and supplements, the prohibition against consumer deception, and then considers and evaluates some specific criticisms that have been made of our enforcement of the law.[2] Since you have indicated a particular interest in the possible application of First Amendment principles to commercial advertising, the [3] companion statement will include discussions relevant to that question. The companion statement is designed to respond to the key questions raised about the unfairness doctrine. However, individual Commissioners may not necessarily endorse particular arguments or particular examples of the Commission's exercise of its unfairness authority contained in the companion statement.

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[1] Unfairness: Views on Unfair Acts and Practices in Violation of the Federal Trade Commission Act (1980) (hereinafter referred to as "Committee Print").

[2] Neither this letter nor the companion statement addresses ongoing proceedings, but the Commission is prepared to discuss those matters separately at an appropriate time.

Commission Statement of Policy on the Scope of the Consumer Unfairness Jurisdiction

Section 5 of the FTC Act prohibits, in part, "unfair . . . acts or practices in or affecting commerce."[3] This is commonly referred to as the Commission's consumer unfairness jurisdiction. The Commission's jurisdiction over "unfair methods of competition" is not discussed in this letter.[4] Although we cannot give an exhaustive treatment of the law of consumer unfairness in this short statement, some relatively concrete conclusions can nonetheless be drawn.

The present understanding of the unfairness standard is the result of an evolutionary process. The statute was deliberately framed in general terms since Congress recognized the impossibility of drafting a complete list of unfair trade [4] practices that would not quickly become outdated or leave loopholes for easy evasion.[5] The task of identifying unfair trade practices was therefore assigned to the Commission, subject to judicial review,[6] in the expectation that the underlying criteria would evolve and develop over time. As the Supreme Court observed as early as 1931, the ban on unfairness "belongs to that class of phrases which do not admit of precise definition, but the meaning and application of which must be arrived at by what this court elsewhere has called 'the gradual process of judicial inclusion and exclusion.' "[7]

By 1964 enough cases had been decided to enable the Commission to identify three factors that it considered when applying the prohibition against consumer unfairness. These were: (1) whether the practice injures consumers; (2) whether it violates established public policy; (3) whether it is unethical or unscrupulous.[8] These factors [5] were later quoted with apparent approval by the Supreme Court in the 1972 case of *Sperry & Hutchinson*.[9] Since then the Commission has continued to refine the standard of unfairness in its cases and rules, and it has now reached a more detailed sense of both the definition and the limits of these criteria.[10]

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[3] The operative sentence of Section 5 reads in full as follows: "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful." 15 U.S.C. 45(a)(1).

[4] In fulfilling its competition or antitrust mission the Commission looks to the purposes, policies, and spirit of the other antitrust laws and the FTC Act to determine whether a practice affecting competition or competitors is unfair. *See, e.g., FTC v. Brown Shoe Co.*, 384 U.S. 316 (1966). In making this determination the Commission is guided by the extensive legislative histories of those statutes and a considerable body of antitrust case law. The agency's jurisdiction over "deceptive acts or practices" is likewise not discussed in this letter.

[5] *See* H.R. Conf. Rep. No. 1142, 63d Cong., 2d Sess., at 19 (1914) (If Congress "were to adopt the method of definition, it would undertake an endless task"). In 1914 the statute was phrased only in terms of "unfair methods of competition," and the reference to "unfair acts or practices" was not added until the Wheeler-Lee Amendment in 1938. The initial language was still understood as reaching most of the conduct now characterized as consumer unfairness, however, and so the original legislative history remains relevant to the construction of that part of the statute.

[6] The Supreme Court has stated on many occasions that the definition of "unfairness" is ultimately one for judicial determination. *See, e.g., FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 249 (1972); *FTC v. R.F. Keppel & Bro.*, 291 U.S. 304, 314 (1934).

[7] *FTC v. Raladam Co.*, 283 U.S. 643, 648 (1931). *See also FTC v. R.F. Keppel & Bro.*, 291 U.S. 304, 310 (1934) ("Neither the language nor the history of the Act suggests that Congress intended to confine the forbidden methods to fixed and unyielding categories").

[8] The Commission's actual statement of the criteria was as follows:

> (1) whether the practice, without necessarily having been previously considered unlawful, offends public policy as it has been established by statutes, the common law, or otherwise—whether, in other words, it is within at least the penumbra of some common-law, statutory, or other established concept of unfairness; (2) whether it is immoral, unethical, oppressive, or unscrupulous; (3) whether it causes substantial injury to consumers (or competitors or other businessmen).

Statement of Basis and Purpose, Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, 29 Fed. Reg. 8324, 8355 (1964).

[9] *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 223, 244–45 n.5 (1972). The Circuit Courts have concluded that this quotation reflected the Supreme Court's own views. *See Spiegel, Inc. v. FTC*, 540 F.2d 287, 293 n.8 (7th Cir. 1976); *Heater v. FTC*, 503 F.2d 321, 323 (9th Cir. 1974). The application of these factors to antitrust matters is beyond the scope of this letter.

Consumer injury

Unjustified consumer injury is the primary focus of the FTC Act, and the most important of the three *S&H* criteria. By itself it can be sufficient to warrant a finding of unfairness. The Commission's ability to rely on an independent criterion of consumer injury is consistent with the intent of the statute, which was to "[make] the consumer who may be injured by an unfair trade practice of equal concern before the law with the merchant injured by the unfair methods of a dishonest competitor."[11]

The independent nature of the consumer injury criterion does not mean that every consumer injury is legally "unfair," however. To justify a finding of unfairness the injury must satisfy three tests. It must be substantial; it must not be outweighed by any countervailing benefits to consumers or competition that the practice produces; and it must be an injury that consumers themselves could not reasonably have avoided.

First of all, the injury must be substantial. The Commission is not concerned with trivial or merely speculative harms.[12] In most cases a substantial injury involves monetary harm, as when sellers coerce consumers into purchasing unwanted goods or [6] services[13] or when consumers buy defective goods or services on credit but are unable to assert against the creditor claims or defenses arising from the transaction.[14] Unwarranted health and safety risks may also support a finding of unfairness.[15] Emotional impact and other more subjective types of harm, on the other hand, will not ordinarily make a practice unfair. Thus, for example, the Commission will not seek to ban an advertisement merely because it offends the tastes or social beliefs of some viewers, as has been suggested in some of the comments.[16]

Second, the injury must not be outweighed by any offsetting consumer or competitive benefits that the sales practice also produces. Most business practices entail a mixture of economic and other costs and benefits for purchasers. A seller's failure to present complex technical data on his product may lessen a consumer's ability to choose, for example, but may also reduce the initial price he must pay for the article. The Commission is aware of these tradeoffs and will not find that a practice unfairly injures consumers unless it is injurious in its net effects.[17] The Commission [7] also takes account of the various costs that a remedy would entail. These include not only the costs to the parties directly before the agency, but also the burdens on society in general in the form of increased paperwork, increased regulatory burdens on the flow of information, reduced incentives to innovation and capital formation, and similar matters.[18]

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[10] These standards for unfairness are generally applicable to both advertising and non-advertising cases.

[11] 83 Cong. Rec. 3255 (1938) (remarks of Senator Wheeler).

[12] An injury may be sufficiently substantial, however, if it does a small harm to a large number of people, or if it raises a significant risk of concrete harm.

[13] *See, e.g., Holland Furnace Co. v. FTC*, 295 F.2d 302 (7th Cir. 1961) (seller's servicemen dismantled home furnaces and then refused to reassemble them until the consumers had agreed to buy services or replacement parts).

[14] Statement of Basis and Purpose, Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. 53506, 53522–23 (1975).

[15] For an example *see Philip Morris, Inc.*, 82 F.T.C. 16 (1973) (respondent had distributed free-sample razor blades in such a way that they could come into the hands of small children) (consent agreement). Of course, if matters involving health and safety are within the primary jurisdiction of some other agency, Commission action might not be appropriate.

[16] *See, e.g.*, comments of Association of National Advertisers, Committee Print at 120. In an extreme case, however, where tangible injury could be clearly demonstrated, emotional effects might possibly be considered as the basis for a finding of unfairness. *Cf.* 15 U.S.C. 1692 *et seq.* (Fair Debt Collection Practices Act) (banning, *e.g.*, harassing late-night telephone calls).

[17] *See Pfizer, Inc.*, 81 F.T.C. 23, 62–63 n.13 (1972); Statement of Basis and Purpose, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59614, 59636 n.95 (1978). When making this determination the Commission may refer to existing public policies for help in ascertaining the existence of consumer injury and the relative weights that should be assigned to various costs and benefits. The role of public policy in unfairness determinations will be discussed more generally below.

Finally, the injury must be one which consumers could not reasonably have avoided.[19] Normally we expect the marketplace to be self-correcting, and we rely on consumer choice—the ability of individual consumers to make their own private purchasing decisions without regulatory intervention—to govern the market. We anticipate that consumers will survey the available alternatives, choose those that are most desirable, and avoid those that are inadequate or unsatisfactory. However, it has long been recognized that certain types of sales techniques may prevent consumers from effectively making their own decisions, and that corrective action may then become necessary. Most of the Commission's unfairness matters are brought under these circumstances. They are brought, not to second-guess the wisdom of particular consumer decisions, but rather to halt some form of seller behavior that unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decisionmaking.[20] [8]

Sellers may adopt a number of practices that unjustifiably hinder such free market decisions. Some may withhold or fail to generate critical price or performance data, for example, leaving buyers with insufficient information for informed comparisons.[21] Some may engage in overt coercion, as by dismantling a home appliance for "inspection" and refusing to reassemble it until a service contract is signed.[22] And some may exercise undue influence over highly susceptible classes of purchasers, as by promoting fraudulent "cures" to seriously ill cancer patients.[23] Each of these practices undermines an essential precondition to a free and informed consumer transaction, and, in turn, to a well-functioning market. Each of them is therefore properly banned as an unfair practice under the FTC Act.[24] [9]

Violation of public policy

The second *S&H* standard asks whether the conduct violates public policy as it has been established by statute, common law, industry practice, or otherwise. This criterion may be applied in two different ways. It may be used to test the validity and strength of the evidence of consumer injury, or, less often, it may be cited for a dispositive legislative or judicial determination that such injury is present.

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[18] For example, when the Commission promulgated the Holder Rule it anticipated an overall lowering of economic costs to society because the rule gave creditors the incentive to police sellers, thus increasing the likelihood that those selling defective goods or services would either improve their practices or leave the marketplace when they could not obtain financing. These benefits, in the Commission's judgment, outweighed any costs to creditors and sellers occasioned by the rule. *See* Statement of Basis and Purpose, Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. 53506, 53522–23 (1975).

[19] In some senses any injury can be avoided—for example, by hiring independent experts to test all products in advance, or by private legal actions for damages—but these courses may be too expensive to be practicable for individual consumers to pursue.

[20] This emphasis on informed consumer choice has commonly been adopted in other statutes as well. *See, e.g.*, Declaration of Policy, Fair Packaging and Labeling Act, 15 U.S.C. 1451 ("Informed consumers are essential to the fair and efficient functioning of a free market economy").

[21] *See, e.g.*, Statement of Basis and Purpose, Labeling and Advertising of Home Insulation, 44 Fed. Reg. 50218, 50222–23 (1979); Statement of Basis and Purpose, Posting of Minimum Octane Numbers on Gasoline Dispensing Pumps, 36 Fed. Reg. 23871, 23882 (1971). *See also Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748 (1976).

[22] *See Holland Furnace Co. v. FTC*, 295 F.2d 302 (7th Cir. 1961); *cf. Arthur Murray Studio, Inc. v. FTC*, 458 F.2d 622 (5th Cir. 1972) (emotional high-pressure sales tactics, using teams of salesmen who refused to let the customer leave the room until a contract was signed). *See also* Statement of Basis and Purpose, Cooling-Off Period for Door-to-Door Sales, 37 Fed. Reg. 22934, 22937–38 (1972).

[23] *See, e.g., Travel King, Inc.*, 86 F.T.C. 715, 774 (1975). The practices in this case primarily involved deception, but the Commission noted the special susceptibilities of such patients as one reason for banning the ads entirely rather than relying on the remedy of fuller disclosure. The Commission recognizes that "undue influence" in advertising and promotion is difficult to define, and therefore exercises its authority here only with respect to substantial coercive-like practices and significant consumer injury.

[24] These few examples are not exhaustive, but the general direction they illustrate is clear. As the Commission stated in promulgating its Eyeglasses Rule, the inquiry should begin, at least, by asking "whether the acts or practices at issue inhibit the functioning of the competitive market and whether consumers are harmed thereby." Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services, 43 Fed. Reg. 23992, 24001 (1978).

Although public policy was listed by the *S&H* Court as a separate consideration, it is used most frequently by the Commission as a means of providing additional evidence on the degree of consumer injury caused by specific practices. To be sure, most Commission actions are brought to redress relatively clear-cut injuries, and those determinations are based, in large part, on objective economic analysis. As we have indicated before, the Commission believes that considerable attention should be devoted to the analysis of whether substantial net harm has occurred, not only because that is part of the unfairness test, but also because the focus on injury is the best way to ensure that the Commission acts responsibly and uses its resources wisely. Nonetheless, the Commission wishes to emphasize the importance of examining outside statutory policies and established judicial principles for assistance in helping the agency ascertain whether a particular form of conduct does in fact tend to harm consumers. Thus the agency has referred to First Amendment decisions upholding consumers' rights to receive information, for example, to confirm that restrictions on advertising tend unfairly to hinder the informed exercise of consumer choice.[25] [10]

Conversely, statutes or other sources of public policy may affirmatively allow for a practice that the Commission tentatively views as unfair. The existence of such policies will then give the agency reason to reconsider its assessment of whether the practice is actually injurious in its net effects.[26] In other situations there may be no clearly established public policies, or the policies may even be in conflict. While that does not necessarily preclude the Commission from taking action if there is strong evidence of net consumer injury, it does underscore the desirability of carefully examining public policies in all instances.[27] In any event, whenever objective evidence of consumer injury is difficult to obtain, the need to identify and assess all relevant public policies assumes increased importance.

Sometimes public policy will independently support a Commission action. This occurs when the policy is so clear that it will entirely determine the question of consumer injury, so there is little need for separate analysis by the Commission. In these cases the legislature or court, in announcing the policy, has already determined that such injury does exist and thus it need not be expressly proved in each instance. An example [11] of this approach arose in a case involving a mail-order firm.[28] There the Commission was persuaded by an analogy to the due-process clause that it was unfair for the firm to bring collection suits in a forum that was unreasonably difficult for the defendants to reach. In a similar case the Commission applied the statutory policies of the Uniform Commercial Code to require that various automobile manufacturers and their distributors refund to their customers any surplus money that was realized after they repossessed and resold their customer's cars.[29] The Commission acts on such a basis only where the public policy is suitable for administrative enforcement by this agency, however. Thus it turned down a petition for a rule to require fuller disclosure of aerosol propellants, reasoning that the subject of fluorocarbon safety was currently under study by other scientific and legislative bodies with more appropriate expertise or jurisdiction over the subject.[30] [12]

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[25] *See* Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services, 43 Fed. Reg. 23992, 24001 (1978), *citing Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council*, 425 U.S. 748 (1976).

[26] *Cf.* Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services, *supra; see also* n.17 *supra.*

[27] The analysis of external public policies is extremely valuable but not always definitive. The legislative history of Section 5 recognizes that new forms of unfair business practices may arise which, at the time of the Commission's involvement, have not yet been generally proscribed. *See* page 4, *supra.* Thus a review of public policies established independently of Commission action may not be conclusive in determining whether the challenged practices should be prohibited or otherwise restricted. At the same time, however, we emphasize the importance of examining public policies, since a thorough analysis can serve as an important check on the overall reasonableness of the Commission's actions.

[28] *Spiegel, Inc. v. FTC*, 540 F.2d 287 (7th Cir. 1976). In this case the Commission did inquire into the extent of the resulting consumer injury, but under the rationale involved it presumably need not have done so. *See also FTC v. R.F. Keppel & Bro.*, 291 U.S. 304 (1934) (firm had gained a marketing advantage by selling goods through a lottery technique that violated state gambling policies); *cf. Simeon Management Corp.*, 87 F.T.C. 1184, 1231 (1976), *aff'd*, 579 F.2d 1137 (9th Cir. 1978) (firm advertised weight-loss program that used a drug which could not itself be advertised under FDA regulations) (alternative ground). Since these public-policy cases are based on legislative determinations, rather than on a judgment within the Commission's area of special economic expertise, it is appropriate that they can reach a relatively wider range of consumer injuries than just those associated with impaired consumer choice.

To the extent that the Commission relies heavily on public policy to support a finding of unfairness, the policy should be clear and well-established. In other words, the policy should be declared or embodied in formal sources such as statutes, judicial decisions, or the Constitution as interpreted by the courts, rather than being ascertained from the general sense of the national values. The policy should likewise be one that is widely shared, and not the isolated decision of a single state or a single court. If these two tests are not met the policy cannot be considered as an "established" public policy for purposes of the *S&H* criterion. The Commission would then act only on the basis of convincing independent evidence that the practice was distorting the operation of the market and thereby causing unjustified consumer injury.

Unethical or unscrupulous conduct

Finally, the third *S&H* standard asks whether the conduct was immoral, unethical, oppressive, or unscrupulous. This test was presumably included in order to be sure of reaching all the purposes of the underlying statute, which forbids "unfair" acts or practices. It would therefore allow the Commission to reach conduct that violates generally recognized standards of business ethics. The test has proven, however, to be largely duplicative. Conduct that is truly unethical or unscrupulous will almost always injure consumers or violate public policy as well. The Commission has therefore never relied on the third element of *S&H* as an independent basis for a finding of unfairness, and it will act in the future only on the basis of the first two. [13]

We hope this letter has given you the information that you require. Please do not hesitate to call if we can be of any further assistance. With best regards,

/s/ Michael Pertschuk
Chairman

/s/ Paul Rand Dixon
Commissioner

/s/ David A. Clanton
Commissioner

/s/ Robert Pitofsky
Commissioner

/s/ Patricia P. Bailey
Commissioner

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[29] A surplus occurs when a repossessed car is resold for more than the amount owed by the debtor plus the expenses of repossession and resale. The law of 49 states requires that creditors refund surpluses when they occur, but if creditors systematically refuse to honor this obligation, consumers have no practical way to discover that they have been deprived of money to which they are entitled. *See Ford Motor Co.*, 94 F.T.C. 564, 618 (1979) *appeal pending*, Nos. 79–7649 and 79–7654 (9th Cir.); *Ford Motor Co.*, 93 F.T.C. 402 (1979) (consent decree); *General Motors Corp.*, D. 9074 (Feb., 1980) (consent decree). By these latter two consent agreements the Commission, because of its unfairness jurisdiction, has been able to secure more than $2 million for consumers allegedly deprived of surpluses to which they were entitled.

[30] *See* Letter from John F. Dugan, Acting Secretary, to Action on Smoking and Health (January 13, 1977). *See also* Letter from Charles A. Tobin, Secretary, to Prof. Page and Mr. Young (September 17, 1973) (denying petition to exercise § 6(b) subpoena powers to obtain consumer complaint information from cosmetic firms and then to transmit the data to FDA for that agency's enforcement purposes).

COMMISSIONER PATRICIA P. BAILEY CONCURRING IN PART AND DISSENTING IN PART

International Harvester manufactured and sold gasoline-powered tractors from 1939 to 1978. By at least 1963, the company had become aware that those tractors were subject to the phenomenon of fuel geysering. That highly dangerous phenomenon is described in the Commission's opinion. Because of this hidden safety hazard, some tractor owners or operators have been badly injured or killed. The question presented here is whether, given Harvester's growing knowledge of the problem, its failure to warn owners and potential buyers constituted an unfair and deceptive practice under Section 5 of the FTC Act.

The Commission has determined that International Harvester had a duty to warn operators of its gasoline-powered tractors of possible fuel geysering and that it failed to do so. I agree. I also concur in the Commission's finding that the company's conduct constitutes an unfair act or practice under Section 5 of the FTC Act, according to the standards set forth in the FTC's 1980 policy statement on unfairness.[1] In addition, while the matter is not free from doubt, I agree, on balance, that the Commission need not issue an order in this matter. [2]

I dissent because the Commission has concluded that Harvester's conduct, while unfair, was not deceptive. In order to reach that conclusion, the Commission has adopted an entirely novel and nearly incomprehensible theory of the law of deception. This is not a complicated case. It is a straightforward example of a manufacturer's duty to warn customers of a latent safety hazard in its product. But the Commission today decides that that failure was not deceptive because it involved a "pure omission" of material fact, which according to this opinion, is *not* a deceptive act or practice.

"Pure omissions" of material fact are characterized in this opinion as seller omissions which involve neither half-truths nor implied misrepresentations, but, rather, stem solely from the seller's failure to correct preexisting erroneous assumptions held by consumers. In such circumstances, according to the opinion, the Commission will look only to its unfairness authority to assess the legality of a particular respondent's conduct. For reasons which I discuss below, I cannot accept this rejection of a well-established and vital component of the FTC's jurisdiction over deceptive acts and practices.

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[1] Letter from Federal Trade Commission to Senators Ford and Danforth (Dec. 17, 1980) (hereinafter cited as "Unfairness Statement").

By at least 1963 and thereafter, as the ALJ found, Harvester was aware that its gasoline-powered tractors were subject to geysering; that many tractor operators were unaware of this hidden hazard; and that some operators had been seriously injured, and even killed, as a result.[2] Looking to prior FTC [3] case law, the ALJ concluded that "[e]ven where no explicit safety claim has been made, as in this case, the Commission has found that the failure to disclose such a hidden, or unknown, hazard is a deceptive practice."[3] He also determined, in accord with Commission precedent, that "[i]n selling its tractors, respondent gives an implied warranty that it is safe to use for its intended use, save any obvious or well-known defects or hazards."[4] Applying these basic deception principles to Harvester's conduct, the ALJ held that the company had a continuing duty from at least 1963 until 1980 to disclose adequately to purchasers and operators that fuel geysering constituted a safety hazard, and that the failure to discharge this duty was a deceptive practice in violation of Section 5.[5]

By this opinion, the Commission reverses the ALJ's conclusion that Harvester's conduct constitutes a deceptive practice under Section 5. In order to reach this conclusion, the Commission rejects the ALJ's finding that Harvester's sale of its gasoline-powered tractors without an adequate warning constituted an implied, but false, representation that the product is safe [4] for its intended use. The Commission resolves this threshhold obstacle by asserting that no implied warranty of fitness for normal use attaches where the statistical risk of incident from an undisclosed hazard is too remote to find that the use of a product is inherently unwise.[6] Because the rate of actual injury from fuel geysering in Harvester tractors was small in relation to the number of tractors sold, the Commission concludes that the respondent made no misrepresentation of safety concerning what it believes was a relatively improbable phenomenon and, therefore, that the first element of the Commission's deception standard, the existence of a representation which is likely to mislead, is not present.[7]

Having found no implied misrepresentation of safety, the Commission concludes that Harvester is guilty of complete silence only. The Commission further concludes that the seller's mere failure to dispel incorrect operator notions about the possible but unlikely consequences of removing or failing to secure the gas cap does not, without more, lead to an assessment of liability under a deception theory. Rather, according to this [5] opinion, if Harvester is to be found liable at all for its silence, then it must be because the injury which ensued outweighed the costs to the company of providing an adequate warning, since only an unfairness theory affords the proper formula for determining whether the benefits to the public of mandating disclosure under such circumstances are greater than the costs of providing it.[8]

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[2] I.D. at 98.

[3] I.D. at 100, citing *Stupell Enterprises, Inc.*, 67 F.T.C. 173, 187, 188 (1965).

[4] I.D. at 100, citing *Stupell Enterprises, Inc.*, 67 F.T.C. 173, 187, 188 (1965); *Seymour Dress & Blouse Co.*, 49 F.T.C. 1278, 1282 (1953); *Academy Knitted Fabrics Corp.*, 49 F.T.C. 697, 701 (1952).

[5] I.D. at 100, citing *Stupell Enterprises, Inc.*, 67 F.T.C. 173, 187, 188 (1965); *Firestone Tire & Rubber Co.*, 81 F.T.C. 398, 456 (1972), *aff'd*, 481 F.2d 246 (6th Cir.), *cert. denied*, 414 U.S. 1112 (1973). The ALJ also determined that Harvester's conduct constituted an unfair practice under Section 5. I.D. at 100.

[6] Slip op. at 27–28.

[7] *Id.* The current Commission majority's views on deception are set forth in a letter from the FTC to Congressman Dingell (Oct. 14, 1983) (hereinafter cited as "Deception Statement"), which is reproduced as an appendix to the Commission's opinion in *Cliffdale Associates, Inc.*, Docket No. 9156 (FTC, March 23, 1984) [103 F.T.C. 110]. I dissented from the issuance of the Deception Statement, and subsequently forwarded a separate analysis to Congressman Dingell (February 28, 1984) (hereinafter cited as "Deception Analysis"), stating the longstanding Commission formulation for finding deception. My views on the law of deception are also contained in a separate opinion in *Cliffdale Associates, Inc.*, *supra.*

I believe the Commission's conclusions are wrong, both as to the existence of an implied representation of safety in this case and as to the broader determination that certain "pure omissions," such as Harvester's, are not deceptive practices. The failure to disclose material facts, whether in the context of a truthful representation that, without more, has the capacity to mislead, an implied misrepresentation, or a completely omitted fact, has long been acknowledged by the Commission and the courts to be an integral part of the law of deception.[9] Specifically, deception may occur when important information is omitted from the sales presentation or from other aspects of a commercial [6] transaction.[10] While in order to be material a misleading omission must generally pertain to a consumer's purchasing decision,[11] it may also concern the use or care of a product.[12]

Significantly, because deception will be found only if consumers could actually be misled by a seller's silence, it is axiomatic that not every material fact about a product must be revealed. Rather, in order to be considered deceptive, the undisclosed facts must be both material and necessary to correct a reasonable false expectation held by a substantial body of consumers, whether that incorrect belief is created by the seller's representations or results from consumers' own [7] expectations in the circumstances of the transaction.[13] Thus, the Commission must first find that consumers have beliefs that are contrary to an undisclosed material fact.[14]

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[8] Slip op. at 20–22.

[9] *See generally* Deception Analysis, *supra* note 7, at 28–30, 57–61. This principle is codified in Section 15 of the Federal Trade Commission Act, which expressly provides that in determining whether an advertisement for a food, drug, device or cosmetic is misleading in a material respect, the Commission shall take into account "the extent to which the advertisement fails to reveal facts material in light of such representations *or material with respect to consequences which may result from the use of the commodity* . . ." 15 U.S.C. 55 (1982) (emphasis added).

[10] *Porter & Dietsch, Inc. v. FTC*, 605 F.2d 294, 303–04 (7th Cir. 1979), *cert. denied*, 445 U.S. 950 (1960); *Simeon Management Corp. v. FTC*, 579 F.2d 1137, 1144–45 (9th Cir. 1978); *J.B. Williams Co. v. FTC*, 381 F.2d 884, 889 (6th Cir. 1967).

[11] *FTC v. Colgate-Palmolive Co.*, 380 U.S. 374, 387 (1965); *American Home Products Corp.*, 98 F.T.C. 136, 368 (1981), *aff'd as modified*, 695 F.2d 681 (3d Cir. 1982).

[12] Care Labeling of Textile Wearing Apparel Rule, 16 C.F.R. 423 (1983) (requiring the disclosure of proper instructions for the laundering and cleaning of clothing).

Also, in the last several years the Commission has alleged in numerous settled cases that information pertaining to the use or care of a product is material to consumers. *E.g.*, *American Motors Corp.*, 100 F.T.C. 229 (1982) (safe use of Jeeps in on-pavement driving); *Chrysler Corp.*, 99 F.T.C. 347 (1982) (use and care information pertaining to the replacement of oil filters in vehicles).

In accordance with these principles, the Commission has found in the past that the nondisclosure of safety risks is deceptive because such warnings are necessary to controvert the consumer's justifiably held assumption of product safety.[15] In addition to what may be generally termed "hazardous commodities" cases, several other categories of FTC matters have at times [8] acquired a "pure omissions" label. These include the failure to disclose the true properties of a product where the appearance of the product, absent disclosure, would mislead the public[16] and silence concerning the foreign origin of a product.[17]

In a number of matters involving seller omissions, the Commission has found that the deception actually derives from or is promoted by implied representations or other actions by the seller.[18] Thus, the Commission has determined that the sale of a product carries with it the implication that the product is safe for the use for which it is sold.[19] As is true under a pure [9] omission analysis, in such instances it is deceptive to market the product absent adequate disclosure of latent safety hazards.[20]

In my judgment, the facts of this matter place it squarely within the ambit of prior Commission decisions involving the deceptive nondisclosure of safety hazards, whether the case is analyzed from an implied representation or pure omission perspective. The evidence demonstrates that geysering is caused by excessive heat and pressure build-up in the fuel tanks of Harvester's gasoline-powered tractors, accompanied by the sudden release of pressure through the removal or loosening of the fuel cap. I.D.F. 19–22. The ALJ found that there was a reasonable likelihood of the gas cap being removed or dislodged in the normal employment of the tractor (I.D.F. 34), but that tractor operators were not aware that such circumstances could lead to a geysering incident I.D.F. 36.

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[13] The Commission has stated that "[t]he principle crystallized in [the caselaw] is that Section 5 forbids sellers to exploit the normal expectations of consumers in order to deceive just as it forbids sellers to create false expectations by affirmative acts." *Statement of Basis and Purpose for the Cigarette Rule*, 29 FR 8324, 8352 (July 2, 1964).

Also, in promulgating the Home Insulation Rule the Commission asserted, "[i]t is an established principle of Section 5 that when a consumer's normal expectations concerning a product are at odds with actual information about the product, this disparity must be corrected through disclosure." *Statement of Basis and Purpose for the Labeling and Advertising of Home Insulation Rule*, 44 FR 50218, 50223 (Aug. 27, 1979).

[14] *See FTC v. Simeon Management Corp.*, 532 F.2d 708, 716 (9th Cir. 1976). In this case, the Commission's request for a preliminary injunction was denied because the courts were unpersuaded that consumers would assume that the drug used in a weight reduction program had been approved for that use by FDA. Ultimately, the Commission's finding that consumers would make such an assumption was upheld. *Simeon Management Corp. v. FTC*, 579 F.2d 1137 (9th Cir. 1978). *See also, Leonard F. Porter, Inc.*, 88 F.T.C. 546 (1976) (Commission declined to find deception in company's failure to disclose origin of products in the absence of evidence showing consumers would assume products were made by Alaskan natives).

[15] *See Stupell Enterprises, Inc.*, 67 F.T.C. 173 (1965); *Fisher & Deritis*, 49 F.T.C. 77 (1972); *Seymour Dress & Blouse Co.*, 49 F.T.C. 1278 (1953); *Academy Knitted Fabrics Corp.*, 49 F.T.C. 697 (1952).

[16] *E.g., Haskelite Mfg. Corp.*, 33 F.T.C. 1212 (1941), *aff'd*, 127 F.2d 765 (7th Cir. 1942).

[17] *E.g., Manco Strap Co., Inc.*, 60 F.T.C. 495 (1962).

[18] For instance, in some cases it has been determined that the normal appearance of a product impliedly represents that it is new or that it is made from a certain material. *See, e.g., Peacock Buick, Inc.*, 86 F.T.C. 1532, 1557–58 (1975), *aff'd*, 553 F.2d 97 (4th Cir. 1977) (opinion unpublished); *Haskelite Mfg. Corp.*, 33 F.T.C. 1212 (1941), *aff'd*, 127 F.2d 765 (7th Cir. 1942).

[19] *See, e.g., Stupell Enterprises, Inc.*, 67 F.T.C. 173, 194 (1965) (offering a product for sale may impliedly represent that it will perform its intended function and do so without posing an unusual risk of harm).

From my review of Commission caselaw, it appears that most if not all of the hazardous commodities cases brought by the FTC under what has been called a "pure omission" theory were also found to involve an implied representation of safety. *See Fisher & Deritis*, 49 F.T.C. 77 (1952); *Seymour Dress & Blouse Co.*, 49 F.T.C. 1278 (1953); *Academy Knitted Fabrics Corp.*, 49 F.T.C. 697 (1952).

[20] *Stupell Enterprises, Inc.*, 67 F.T.C. 173 (1965).

At the same time, this record reveals beyond doubt that at least as early as 1963, the company was on notice from numerous reported field incidents, as well as from its own in-house tests, that the design of its tractors was a contributing factor to pressure build-up which could lead, under a combination of normal circumstances, to accidents resulting in serious injury or death. I.D.F. 276. This awareness is evidenced by numerous company documents placed on the record in this matter, including a 1964 written report from the company's own engineers that [10] characterized the vaporization of fuel and accompanying rises in fuel tank pressure in Harvester's gasoline-powered tractors as ". . . constituting a definite safety hazard." I.D.F. 98–100.

On the basis of this and other information, the ALJ found that Harvester knew or should have known that geysering accidents would continue in the absence of an effective warning. I.D.F. 276. Yet from 1963 through 1976, Harvester made no changes in its basic fuel warning instructions, and in fact did not provide an appropriately instructive warning to existing tractor owners until the summer of 1980. I.D.F. 164–166, 277. At the same time, the ALJ determined that information concerning geysering and the steps which should be taken to avoid it might well have affected the purchasing decisions of tractor owners, as well as their methods of maintaining and using Harvester gasoline-powered tractors.[21]

Commission law holds that a manufacturer impliedly warrants the safety of its product in normal use and that the manufacturer must disclose specific safety hazards which are not obvious to the users of its products.[22] Given Harvester's own in-plant characterization of fuel geysering as a safety hazard, as well as other information in this record documenting the company's [11] burgeoning awareness over the course of many years of the risks and possibly injurious results of geysering, I do not see how it is possible to conclude, as the Commission does here, that Harvester's overall implied representation of product safety did not encompass this particular safety hazard.

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[21] I.D.F. 37. While there is express evidence of materiality in this case, safety-related information has been found by the Commission to be presumptively material to consumers. *See Firestone Tire & Rubber Co.*, 81 F.T.C. 398 (1972), *aff'd*, 481 F.2d 246 (6th Cir.), *cert. denied*, 414 U.S. 1112 (1973).

[22] *See Stupell Enterprises, Inc.*, 67 F.T.C. 173 (1965); *Seymour Dress & Blouse Co.*, 49 F.T.C. 1278 (1953); *Academy Knitted Fabrics Corp.*, 49 F.T.C. 697 (1952); *Fisher & Deritis*, 49 F.T.C. 77 (1952).

Putting aside for the moment Harvester's implied representation of safety, I believe that these same facts define a basis for finding that the company's silence about geysering in the face of reasonable consumer beliefs about the safety of its product was a deceptive practice under Section 5. Since consumers' normal expectations are that, in the absence of a warning to the contrary, products can be used safely, they are likely to be deceived if a product is dangerous and the warning is omitted.[23]

Here, the ALJ properly concluded that farmers and farm experts alike reasonably believed that removing or improperly fasteining the fuel cap on a gasoline-powered tractor was not an especially dangerous practice, even though it was unadvised, and that Harvester was aware of this common procedure. I.D.F. 36, 52. (Indeed, some of Harvester's own employees removed gas caps during tests at company facilities while tractors were still hot or running. I.D.F. 34.) In view of the cumulative knowledge Harvester possessed concerning the circumstances which could lead to geysering and the substantial risk of injury if it occurred, [12] as well as the almost complete lack of information available to tractor operators about this possibility, I believe it is patent that Harvester's unwillingness or delay in disclosing this potential hazard had the tendency to deceive numerous tractor operators in a highly material respect. Such conduct is, by definition, deceptive under Section 5.[24]

My strong disagreement in the instant matter does not end with the Commission's rejection of FTC precedent to find that there was no element of deceit in Harvester's conduct. Rather, I find it necessary to address several aspects of the Commission's underlying reasoning and policy assumptions as well.

First, I am frankly dismayed by the Commission's reliance on the statistical probability of physical harm to find that Harvester's general implied representation of safety did not extend to fuel geysering. There is simply no basis in Commission law for requiring that the rate of injury from a latent hazard reach some threshhold level before the Commission will infer a misrepresentation of an implied warranty of safety from a seller's silence.[25] To the contrary, an implied representation [13] of safety, like any representation the Commissiom might consider, conveys a message that can be ascertained when it is made; the message does not change its meaning under varying circumstances nor depend for its interpretation on *ex post facto* analyses of later developments. The Commission's suggestion that an implied representation of safety, made at the time a product is sold, is somehow limited after the fact when the product proves to be unsafe (but not so unsafe as to kill more than a few people) cannot be sustained legally or logically.

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[23] *See Cigarette Statement, supra* note 13, 29 FR at 8352; *see also Stupell Enterprises, Inc.,* 67 F.T.C. 173 (1965).

[24] *See Stupell enterprises, Inc.,* 67 F.T.C. 173 (1965); *Fisher & Deritis,* 49 F.T.C. 77 (1952); *Seymour Dress & Blouse Co.,* 49 F.T.C. 1278 (1953); *Academy Knitted Fabrics Corp.,* 49 F.T.C. 697 (1952).

[25] Commission law holds, of course, that materiality does not require a demonstration of actual injury to consumers in deception cases. (*E.g., Simeon Management Corp.,* 87 F.T.C. 1184, 1229 (1976), *aff'd,* 579 F.2d 1137 (9th Cir. 1978).) I am concerned, however, that the Commission's reliance on a finding of injury here in order to infer the existence of a misrepresentation of safety by the seller may create a *de facto* injury requirement for certain categories of deception cases, such as those involving hazardous products.

If the Commission does not contend—as it cannot possibly—that *no* representation of safety from fuel geysering was made, then the opinion must mean that the representation was made but, because of the low incidence of injury, was not likely to mislead. Rather than focusing on a product's actual accident rate to determine whether an implied representation of safety is misleading, however, I believe the Commission should instead determine whether the existence of factors giving rise to a particular type of incident can reasonably be expected to occur, thereby placing substantial numbers of consumers at risk. The frequency of accidents merely helps to substantiate the presence of a substantial risk, the existence of which may already be known or foreseeable to the seller.

Here, the ALJ concluded that there was the potential for heat and pressure build-up in *all* Harvester tractors of a particular type. I.D.F. 8, 22. As I have noted, he also found that it was reasonably likely that tractor operators would remove or fail adequately to secure the gas cap during the normal [14] operation of their vehicles. I.D.F. 34.[26] The combination of these factors introduced a substantial risk of an accident which could lead to injury or death, the existence of which was further confirmed by numerous reports to Harvester of geysering incidents. Thus, while the *rate* of actual physical injury from geysering may have been only .001 percent, the *risk* of a fuel geysering incident, and the accompanying possibility of harm, was present each and every time the operator used his Harvester machinery in the field. It is the foreseeability of this substantial risk of injury, coupled here with Harvester's actual notice of the problem—and not some arbitrary number of injuries or deaths—which gives rise to a duty to warn consumers about the hazards of fuel geysering and leads to a finding of deception in the absence of such a disclosure.[27] [15]

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[26] The Commission readily admits that the potential for geysering was an inherent drawback of Harvester tractors (slip op. at 4), that the loosening of the gas cap was likely to occur pursuant to the normal use of its tractors (slip op. at 34), and that serious injury and death have resulted from fires started in connection with fuel geysering (slip op. at 6). Yet, for reasons which I do not fully comprehend, the Commission is ultimately able to conclude that the risk of geysering was not sufficiently foreseeable to be included in Harvester's implied representation of safety.

[27] *See generally Billiar v. Minnesota Mining & Manufacturing Co.*, 623 F.2d 240, 246 (2d Cir. 1980) (court found that if injury is reasonably foreseeable, "the seller cannot rely on its history of good fortune" to exempt itself from a duty to disclose.)

The inappropriateness of examining the rate rather than the risk of harm in determining whether the nondisclosure of health or safety information is deceptive is brought into even sharper relief by varying the facts slightly

(footnote cont'd)

Second, I cannot accept the Commission's conclusory finding that only a cost-benefit analysis can prevent a conceptually open-ended category of "pure omissions" from requiring the correction of literally all product-related misconceptions consumers may have.[28] While the FTC's deception authority clearly encompasses deception by silence, the Commission has actually exercised its powers judiciously against such conduct. In large measure, this reflects the Commission's understanding that sellers are held legally accountable for correcting a disparity between normal consumer expectations that the sellers may have had little direct role in creating and truthful information about a product. In recognition of this additional responsibility, the Commission has held, for example, that silence can be deceptive only where erroneous consumer **[16]** expectations about a product are normal and reasonable[29] and where danger is not readily observable to the user of a product.[30]

There is an even more fundamental safeguard against unwarranted results, however, and that is the deception standard itself, evolved by the Commission and the courts over a fifty year period to analyze potentially misleading conduct. Contrary to the Commission's implication that there is a virtual "per se" standard for deceptive conduct, a finding of deception actually requires specific and well-developed findings by the Commission, based on the facts of each case, as to each of the three principal components of deception. Thus, the Commission must determine in all cases that there is (1) a representation or omission capable of misleading (2) a substantial number of **[17]** consumers (3) as to a material product purchasing or use decision before liability may be found.[31] Most "omissions" of product or use information could not be ruled deceptive under this standard.

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in the instant case. Assume, for example, that Harvester continued its policy of silence until one hundred and thirty farmers—ten times as many as this record shows—had been severely disfigured or killed. Would a .01 percent incidence of harm bring geysering within Harvester's implied representation of safety, such that the failure to disclose this hazard would be misleading, or would such conduct continue to be characterized as unfair only by the Commission? While tractor operators who continued to use the product would be justifiably alarmed to learn of a company's continued silence in the face of so many injuries and deaths, the fact remains that the overall *rate* of actual harm is still quite low, so that the Commission's analysis suggests such conduct might not be found to be deceptive. Such an anomalous result can best be avoided by focusing on traditional factors, such as the foreseeability to the seller that an accident will occur, to find an implied warranty of safety.

[28] It is particularly strained reasoning to suggest, as the Commission does here, that considering pure omissions to be deceptive could lead to television and print advertisements overflowing with required disclosures. Pure omissions have been challenged by the Commission for decades now without producing such dire results. Furthermore, there are numerous other vehicles for disclosing product information besides advertising, such as product warning stickers or instruction manuals.

[29] *See Cigarette Statement, supra* note 13, 29 FR at 8352. Contrary to the Commission's assertion that the *Cigarette Statement* does not provide a basis for considering pure omissions to be deceptive, the statement specifically addresses pure omissions in its discussion of deceptive nondisclosures, citing to a number of cases which are generally characterized as examples of complete nondisclosures. *Id.* at 8352, 8356.

[30] *Stupell Enterprises, Inc.*, 67 F.T.C. 173, 188 (1965).

[31] *See* Deception Analysis at 17–18. While the deception standard has been interpreted through the years to permit a shorthand variant to be applied in some instances, such as where materiality may be inferred, this is certainly not always the case. As I have already noted, for example, evidence of consumer perceptions concerning a product may be required in certain cases of deception by omission. *See, e.g., FTC v. Simeon Management Corp.*, 579 F.2d 1137 (9th Cir. 1978).

Additionally, where pure omissions have been found to be deceptive, the Commission has generally found an implied representation by the seller as well.[32] As a result of the care and caution with which the Commission approaches deception cases generally, and deception by omission matters in particular, the Commission has applied the doctrine of deception by nondisclosure to only a few narrow categories of particularly significant omissions, such as those involving safety matters where the potential for injury from a misleading omission would be greatest.[33]

Finally, I fail to see the relevance of the Commission's conclusion that the nature of pure omissions is such that they do not presumptively reflect deliberate conduct on the part of the [18] seller. This conclusion is in the first place simply wrong, since the act of selling a product is itself a deliberate act that can create expectations on the part of consumers.

More importantly, this judgment incorrectly highlights the *form* conduct takes rather than the *result*. As set forth by the Commission in the *Cigarette Statement*, whether the offending conduct includes express or implied representations or nondisclosure of material information, "[t]he test is simple and pragmatic: Is it likely that, unless such disclosure is made, a substantial body of consumers will be misled to their detriment?"[34] Thus, the Commission has found on numerous occasions that deception is actionable in whatever form it appears, including complete silence under certain circumstances.[35]

Moreover, because the Commission has traditionally focused on the effects of conduct in order to afford the most protection possible for the public, it is not necessary to examine whether a seller engaging in a potentially misleading practice intends to [19] deceive or acts in bad faith. In fact, the Commission may prohibit conduct that is capable of misleading consumers even when it is unintentional or carried out in good faith.[36]

In view of the Commission's ultimate finding of liability under an unfairness theory in this case, I would like to believe that, at worst, this matter reflects injudicious but benign legal engineering by the Commission. Unfortunately, although I can only speculate as to the precedential value of this opinion, it appears that one practical effect may be to limit the types of hazardous commodities cases which may be brought under a deception theory in the future.[37] Indeed, the Commission specifically notes that a number of prior cases holding both that implied representations of safety were breached and that nondisclosures by sellers are deceptive would probably be brought **[20]** exclusively under an unfairness theory today.[38] Though unfairness does provide an alternative ground for action, the Commission's apparent abandonment of applicable deception theory is nevertheless troubling for several reasons.

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[32] *See, e.g., Peacock Buick, Inc.*, 86 F.T.C. 1532 (1975), *aff'd*, 553 F.2d 97 (4th Cir. 1977) (opinion unpublished).

[33] *E.g., Fisher & Deritis*, 49 F.T.C. 77 (1952); *Stupell Enterprises, Inc.*, 67 F.T.C. 173 (1965).

[34] *Cigarette Statement, supra* note 13, 29 FR at 8352.

[35] *See Stupell Enterprises, Inc.*, 67 F.T.C. 173 (1965); *Seymour Dress & Blouse Co.*, 49 F.T.C. 1278 (1953); *Academy Knitted Fabrics Corp.*, 49 F.T.C. 607 (1952).

Such a finding is also consonant with developments in the common law, including a growing willingness on the part of courts to permit an action in deceit for tacit nondisclosures, particularly in cases involving latent safety hazards where one party has special knowledge, or means of knowledge, which would be important to but is not known by another party. *See* Prosser, *Handbook of the Law of Torts*, Section 106 at 697–98 (4th Ed. 1971).

[36] *Chrysler Corp. v. FTC*, 561 F.2d 357, 363 & n.5 (D.C. Cir. 1977); *Feil v. FTC*, 285 F.2d 879, 896 (9th Cir. 1960); *Travel King, Inc.*, 88 F.T.C. 715, 773 (1975). Although intent to deceive is neither required by nor necessarily presumed by the Commission in deception cases, given the record evidence here of Harvester's longstanding awareness of the risks attendant to fuel geysering, I find it somewhat disingenuous for the Commission to suggest that seller silence *cannot* presumptively reflect the deliberate withholding of information. It can, but it simply isn't necessary to find or presume that intent exists in order to charge a seller with deception.

In addition to ignoring FTC precedent, the Commission's findings in this case are directly contrary to established Commission policy. In applying its deception analysis the Commission has traditionally required *higher* standards of candor and honesty in the area of what may be broadly termed "dangerous products."[39] Thus, whether a practice is found to be deceptive may in part actually depend upon whether the normal use of the product involves danger to health or safety, with the standard for honesty and full and fair disclosure highest where the degree of risk involves not only health or safety but possibly life itself.[40]

The reasons for this policy are apparent. While the effects of economic loss to consumers as a result of a seller's silence may be serious, they can never be of such consequence as potential injury to their persons. The Commission's novel **[21]** conclusion that, despite what a seller should or may know about hidden product hazards, the FTC will employ some form of *ex post* statistical analysis to determine whether a seller's silence is misleading, followed by a cost-benefit examination to determine whether the seller's conduct is unfair, cannot be reconciled with these established policies.

Potentially more troubling, however, is that, while the Commission would continue to analyze "pure omissions" under an unfairness theory, such a policy offers far fewer guarantees that a seller's silence would be corrected in advance of rather than after injury has occurred, or if it would be redressed at all. In relying on unfairness to find liability here, the Commission correctly states that "unfairness cases usually involve actual and completed harms."[41] While the Unfairness Statement clarifies that unwarranted health and safety risks are also covered,[42] the clear focus of the Statement generally, as well as of the deception and unfairness inquiries conducted by the Commission in this case, is on substantial, completed injury.

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[37] It is uncertain from the Commission's opinion whether other traditional categories of actionable "pure omissions," such as those involving the foreign origin of a product, would find a safe harbor under an implied representation theory or would also be required to undergo a rigorous cost-benefit analysis to be found illegal under Section 5.

[38] Slip op. at 28–29.

[39] *See Cigarette Statement, supra* note 13, 29 FR at 8353. Sellers are, of course, in a far better position than are purchasers to be aware of latent hazards connected with the normal use of their products, as well as to assess the potential effects of their failure to disclose the existence of product hazards, regardless of the source of consumer misperceptions about such dangers. *See also Firestone Tire & Rubber Co. v. FTC,* 81 F.T.C. 398 (1972), *aff'd,* 481 F.2d 246 (6th Cir.), *cert. denied,* 414 U.S. 1112 (1973).

[40] *Cigarette Statement, supra* note 13, 29 FR at 8354.

Deception analysis, of course, requires only that a representation or omission have a tendency or capacity to deceive. Actual harm, physical or economic, need not have [22] occurred to find a practice deceptive.[43] Thus, while an after-the-fact unfairness approach may be necessary to address conduct which is clearly not deceptive,[44] I believe that the substantial public interest in stopping seller misconduct in its incipiency—well before it exposes consumers to serious risks or leads to actual physical harm—militates in favor of continued Commission reliance on *both* deception and unfairness bases for liability wherever possible. The Unfairness Statement clearly contemplates the need to employ both forms of analysis wherever necessary to protect the public interest.[45]

Contrary to the Commission's conclusory statements in this opinion, the FTC's cautious and consistent approach to pure omissions has provided substantial guidance both to the Commission in terms of following its own precedent and to sellers who seek to comply with the law by looking to such precedent. Changing the law at this juncture will only inject immediate [23] confusion as to the status of the law of deception generally in cases of seller silence, without affording any additional longterm certainty.[46]

In light of the foregoing discussion, I must disassociate myself fully from the Commission's ill-advised departure from traditional analysis of a potentially deceptive form of behavior. The record in this matter is clear. International Harvester had reason to be aware for literally decades that fuel geysering presented a substantial risk of injury or death, yet the company failed to issue an effective warning to tractor operators until the initiation of its fire prevention program in 1980.

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[41] Slip op. at 23.

[42] Unfairness Statement at 6.

[43] As the Third Circuit has stated, "[t]he purpose of the Federal Trade Commission Act is to protect the public, not to punish a wrongdoer . . . and it is in the public interest to stop any deception at its incipiency." *Regina Corp. v. FTC*, 322 F.2d 765, 768 (3rd Cir. 1963).

[44] *See, e.g., Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services*, 43 FR 23992 (1978).

[45] *See* "Companion Statement on the Commission's Consumer Unfairness Jurisdiction" at 5. Cases often cited for the proposition that the Commission may stop undue health and safety risks under an unfairness theory, such as *Philip Morris, Inc.*, 82 F.T.C. 16 (1973), generally involve a finding of deception by the Commission as well.

[46] I fail to see, for example, how future Commissions or sellers will divine with any greater clarity than is true under a deception analysis what forms of seller silence will be considered "unfair" by the Commission or how the unfairness criteria will be applied to particular facts on the basis of this opinion. The law of deception involves well-settled principles which are seriously jeopardized by the sort of unnecessary judicial tinkering present in this case.

The withholding of such vital product safety information, particularly where its value to consumers is as clearly foreseeable as the facts would suggest here, is, in accordance with established FTC precedent, *both* a deceptive and unfair practice under Section 5. In my view, the Commission presents no sound legal or policy reasons to justify its detour from the Commission's traditional law of deception.

FINAL ORDER

This matter has been heard by the Commission upon the appeal of counsel supporting the complaint, and of counsel for the respondent, and upon briefs and oral argument in support of and in opposition to these appeals. For the reasons stated in the accompanying opinion the Commission has determined to affirm in part and reverse in part the Initial Decision. Therefore,

It is ordered, That the Initial Decision of the administrative law judge be adopted as the Findings of Fact and Conclusions of Law of the Commission, except as is inconsistent with the accompanying opinion. Other Findings of Fact and Conclusions of Law are contained in the accompanying opinion.

Commissioner Bailey concurred in the result and as to the finding of liability on unfairness grounds and dissented as to the remainder of the Commission's opinion; and Commissioner Azcuenaga did not participate.

In the Matter of

CHARLES E. WELLER

CONSENT ORDER, ETC., IN REGARD TO ALLEGED VIOLATIONS OF SEC. 5 OF THE FEDERAL TRADE COMMISSION ACT

Dkt. C-3149. Complaint, Dec. 24, 1984—Decision, Dec. 24, 1984

This Consent Order, among other things, requires Charles E. Weller to cease misrepresenting the value or potential value of oil and gas rights or other investments offered; the degree of risk involved in such investments; or the value or potential for increase in value of any mineral right or other investment offering. The respondent is also required to substantiate any representation or claim concerning the value or potential earnings of any investment; make prescribed disclosures in sales brochures and oral sales presentations advising consumers that oil and gas lease rights are high risk investments; and place $60,000 into an escrow account to be used for consumer redress.

Appearances

For the Commission: *David J. Federbush* and *Arthur B. Cornell.*

For the respondent: *Stephen V. Wilson, Hochman, Salkin and DeRoy,* Beverly Hills, California.

COMPLAINT

The Federal Trade Commission ("Commission"), pursuant to the provisions of the Federal Trade Commission Act ("FTC Act"), 15 U.S.C. 41 *et seq.*, as amended, and by virtue of the authority vested in it by said Act, having reason to believe that Charles E. Weller ("respondent") has violated the provisions of said Act, and believing that a proceeding by it in respect thereof would be in the public interest, hereby issues its complaint stating its charges as follows:

RESPONDENT AND RESPONDENT'S BUSINESS

PARAGRAPH 1. Respondent Charles E. Weller was, until April 1983, a Director and President of Alaska Land Leasing, Incorporated ("ALL"), an Alaska corporation with its principal office currently located at 11726 San Vicente Boulevard, Los Angeles, California, and previously located at 28990 Pacific Coast Highway, Malibu, California. He was also, until April 1983, General Counsel and Executive Vice President of Federal Lease Filing Corporation ("FLFC"), a California corporation with its principal office located at 28990 Pacific Coast Highway, Malibu, California. Individually or in concert with others, he was directed, controlled, or formulated business practices of ALL and FLFC.

PAR. 2. Beginning around August 1982 and continuing thereafter, ALL has maintained a substantial course of trade in the sale of leases to the oil and gas exploration and development rights to public lands located in the state of Alaska. ALL has purchased or had related companies or third persons purchase, and resold such leases pertaining to tracts of federal lands managed by the United States Bureau of Land Management ("BLM lands"), including leases pertaining to substantial acreage in the Minchumina and Denali leasing blocks in central Alaska. ALL has also purchased or had related companies purchase, and resold such leases pertaining to tracts of Alaska state lands, including leases pertaining to substantial acreage made available through state sale 34 in the Prudhoe Bay Uplands. ALL subdivided these leases to pertain to smaller tracts, often as small as 40 to 640 acres, and has promoted the sale of these leases to consumers across the United States through telephone sales presentations and written promotional material. FLFC, a filing service for the federal lottery for leases to BLM lands in the lower 48 states, has similarly promoted the sale of such leases to consumers, and during the time of Weller's employment there sold such leases pursuant to an agreement with ALL.

PAR. 3. Defendant's course of trade is in or affecting commerce, as "commerce" is defined in Section 4 of the FTC Act, 15 U.S.C. 44.

RESPONDENT'S VIOLATIONS OF SECTION FIVE OF THE FTC ACT

PAR. 4. Respondent, personally or through the actions of ALL and FLFC, has falsely represented to their customers, expressly or by implication, that leases to BLM lands in the Minchumina and Denali blocks they have offered for sale are leases to lands which have good or high potential for oil and gas production. In fact, these lands have little or no potential for oil and gas production.

PAR. 5. Respondent, personally or through the actions of ALL and FLFC, has falsely represented to their customers, expressly or by implication, that the leases to state sale 34 lands in the Kavik and Kemik areas of the Prudhoe Bay Uplands they have offered for sale are leases to lands which have good or high potential for oil and gas production. In fact, these lands have little or no potential for oil and gas production.

PAR. 6. Respondent, personally or through the actions of ALL and FLFC, has falsely represented to their customers, expressly or by implication, that their leases to the lands described in paragraphs Four and Five were selected or recommended for purchase by their geologist or team of geologists, experts, or analysts for their oil and gas production potential. In fact, no geologist or team of geologists, experts or analysts selected or recommended that ALL or FLFC purchase leases in those areas.

PAR. 7. Respondent, personally or through the actions of ALL and FLFC, has falsely represented to their customers, expressly or by implication, that the leases they have offered for sale to lands described in paragraphs Four and Five are low-risk investments or that these leases are likely to increase in value and produce substantial income. In fact, these leases are high-risk investments and are unlikely to increase in value or produce income.

PAR. 8. Respondent, personally or through the actions of ALL and FLFC, has represented to their customers, expressly or by implication, that the leases they have offered for sale have good or high potential for oil and gas production. Respondent, through the actions of ALL and FLFC, has deceptively failed to disclose to their customers that subdividing leases into interests pertaining to 640 or fewer acres in itself makes it unlikely that the lease property will be explored or developed for oil and gas production.

PAR. 9. Each of respondent's misrepresentations of or failures to disclose material facts, as described in paragraphs Four through Eight above, was deceptive in violation of section 5(a) of the FTC Act.

CONSUMER INJURY

PAR. 10. Respondent's misrepresentations of and failures to disclose material facts have induced consumers to spend substantial sums of money to purchase leases offered for sale by ALL and FLFC. The leases described in paragraphs Four and Five are of little or no value and ALL's and FLFC's customers have therefore lost virtually all the money they invested to purchase those leases.

Commissioner Azcuenaga abstained.

DECISION AND ORDER

The Federal Trade Commission having initiated an investigation of certain acts and practices of the respondent named in the caption hereof, and the respondent having been furnished thereafter with a copy of a draft of complaint which the Bureau of Consumer Protection proposed to present to the Commission for its consideration and which, if issued by the Commission, would charge respondent with violation of the Federal Trade Commission Act; and

The respondent, his attorney, and counsel for the Commission having thereafter executed an agreement containing a consent order, an admission by the respondent of all the jurisdictional facts set forth in the aforesaid draft of complaint, a statement that the signing of said agreement is for settlement purposes only and does not constitute an admission by respondent that the facts as alleged in the complaint are true or that any law has been violated as alleged in such complaint, and waivers and other provisions as required by the Commission's Rules; and

The Commission having thereafter considered the matter and having determined that it had reason to believe that the respondent has violated the said Act, and that complaint should issue stating its charges in that respect, and having thereupon accepted the executed consent agreement and placed such agreement on the public record for a period of sixty (60) days, and having duly considered the comment filed thereafter by an interested person pursuant to Section 2.34 of its Rules, and having thereafter accepted a modification to the consent agreement, approved by respondent and counsel for the Commission, which permits the Commission to transfer funds paid by respondent for redress purposes to the receiver appointed in the Commission's related federal district court action to be disbursed appropriately by the receiver under court supervision, now in further conformity with the procedure prescribed in Section 2.34 of its Rules, the Commission hereby issues it complaint, makes the following jurisdictional findings and enters the following order:

1. Respondent Charles E. Weller was, until April 1983, a Director and President of Alaska Land Leasing, Incorporated, an Alaska corporation with its principal office then located at 28990 Pacific Coast Highway, Malibu, California. He was also executive vice president and general counsel of Federal Lease Filing Corporation, a California corporation with its principal office located at 28990 Pacific Coast Highway, Malibu, California, until April 1983.

2. The Federal Trade Commission has jurisdiction of the subject matter of this proceeding and of the respondent, and the proceeding is in the public interest.

ORDER

I.

It is hereby ordered, That respondent Charles E. Weller, his successors and assigns, and respondent's agents, representatives, and employees, directly or through any corporation, subsidiary, division or other device, in connection with the advertising, offering for sale, sale or promotion of any mineral right, including any oil and gas lease right, or other investment offering in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

(1) Misrepresenting, directly or by implication,

(a) the value, or potential for increase in value, of any mineral right or other investment offering, including, but not limited to, the potential for oil or gas discovery or production on any property, the proximity of any property to a proven oil or gas reserve, the geologic structure of any property, or the existence of, or access to, any pipeline to transport oil or gas from any property;

(b) the past or likely future success of anyone in realizing profits, obtaining income, or gaining anything of value from any mineral right or other investment offering, including, but not limited to, the resale value of any oil and gas lease right or the royalty income from any oil and gas lease right;

(c) the degree of risk in any investment offering or in the acquisition of any mineral right;

(d) the findings, conclusions or substance of any report, analysis, recommendation or other advice by defendant or anyone else, including a geologist, concerning the geologic potential, value or potential for increase in value of any mineral right or other investment offering;

(e) any purchase, offer to purchase or bid by anyone, including an oil company, for any mineral right or other investment offering;

(f) any mineral exploration, discovery or production, including drilling, on any property or the production status of any dry, capped, suspended or abandoned oil or gas well;

(2) Representing, directly or by implication, the value or potential for increase in value of any mineral right or other investment offering either by reference to any land or fixtures thereon, by reference to any earnings, profits or income anyone has made or may make, or by any other reference, or representing, directly or by implication, any other of the matters referred to in part (1)(a)-(f) above, unless at the time such representation is made respondent or his successors and assigns possess and rely upon competent and reliable evidence that substantiates the representation.

(3) Failing to disclose clearly and conspicuously (as set forth below) in every sales brochure given or shown to any prospective purchaser (other than one of the top 200 oil and gas producing companies as ranked by total assets in the then current *U.S.A. Oil Industry Directory* published by the PennWell Publishing Company of Tulsa, Oklahoma) of any mineral right or other investment offering statements (a)-(e) below, and failing to disclose clearly and conspicuously (as set forth below) in every sales contract and sales or service agreement

given or shown to any of those prospective purchasers statements (a)-(f) below:

(a) "The [partnerships in (where applicable)] oil and gas leases we offer are extremely speculative and very high risk investments. Do not invest unless you can afford and are prepared to lose all the money invested."

(b) When any geologist has reported to respondent that respondent's lease property or the area in which that lease property is located has little or no potential for oil or gas reserves,

"(A) [g]eologist(s) report(s) to us that this area has little or no potential to contain oil or gas. A copy of (all) the geologist report(s) on this area is (are) available upon request."

(c) When offering lease rights to 640 or fewer contiguous acres of property that contain no proven oil or gas reserves,

"Even if oil or gas were located on our lease property, a lease property size in this area of 640 of fewer acres will make it unlikely that oil or gas drilling will occur."

(d) When making any reference to oil company ownership of, bidding for or attempts to purchase leases to property that is nearby, or in the same leasing block as, respondent's lease property,

"Oil company ownership of or attempts to acquire other leases in this area don't mean that oil or gas is likely to be found on or anywhere near our lease property. In fact, no oil company attempted to acquire the lease(s) we're offering to you" (when such is the case).

(e) When making any reference to any oil or gas discovery, production or exploration on property that is nearby or in the same leasing block as respondent's lease property,

"Oil or gas found nearby, or in the same leasing block as, our lease property doesn't assure that oil or gas is located on our lease property. The likelihood of reserves depends on geologic structure, which can be different even for adjoining areas."

(f) "This agreement [or contract] shall not be deemed valid or complete unless the customer has signed and dated the required declaration of understanding printed herein."

The statements required above shall be disclosed in sales or service agreements and sales contracts in print at least as large as the capitalized corporate name within the text of the contract or agreement, but in no event smaller than 10 point type. Such statement shall be printed in 100% black ink against a white background, and boxed. The copy of the foregoing statements included on each sales or service agreement or sales contract shall also include a signature line for the customer preceded by a declaration that the customer has read and understands the statement. The statement required by part 3(a) above shall also be disclosed, in the size and format described above, on the front cover of every sales brochure. The statements required by parts 3(b)-(e) shall be disclosed in sales brochures in the same size and format described above on the first page of the brochure.

(4) Failing to disclose orally in every oral sales presentation given to any prospective purchaser (other than one of the top 200 oil and gas producing companies as ranked by total assets in the then current *U.S.A. Oil Industry Directory* published by the PennWell Publishing Company of Tulsa, Oklahoma) of any mineral right or other investment offering the statements required by parts (3)(a)-(e) above.

II.

It is further ordered, That respondent Charles E. Weller shall deposit, no later than five (5) days after his attorney is served with a copy of a notice of the acceptance of the Consent Agreement containing this Order by the Commission pursuant to section 2.34(1) of its Rules of Practice, a certified check for $60,000 into an escrow account established and managed by the United States Treasury for the Federal Trade Commission, such funds to be used for such consumer redress purposes as the Commission shall decide upon after final disposition of the action against Alaska Land Leasing, Incorporated and Federal Lease Filing Corporation and other officers, directors and salesmen of those corporations, *FTC v. Alaska Land Leasing Inc.,* Civ. No. 84-5416 AWT(Px) (C.D. Cal., filed July 23, 1984); *provided, however,* that the Commission may transfer these funds to the receiver appointed in the above-mentioned federal district court action, such funds to be disbursed under court supervision pursuant to the Order Appointing a Permanent Receiver in that case, entered October 31, 1984.

III.

It is further ordered, That respondent shall, within sixty (60) days after the date of service of this Order, file with the Commission a report, in writing, setting forth in detail the manner and form in which he has complied with the Order.

Commissioner Azcuenaga abstained.

[illegible] provided [illegible] a [illegible] that the [illegible] Constitution [illegible] shall also be disclosed, to the day and hour described above, on the [illegible]

[illegible]

[illegible]

It is further ordered That [illegible] shall, within [illegible] days after [illegible] setting forth [illegible] he has complied with the Order.

CHARLES E. WYZANSKI, JR.

[illegible]

Manufacturing of polypropylene using propylene as a feedstock constitutes "petrochemical processing" and is an "oil and gas related asset" within the meaning of the Consent Order issued against respondent. (104 F.T.C. 597 (1984)) [*Gulf Oil Corporation, Dkt. C-3147*]

Nov. 8, 1984

Dear Mr. Whitman:

The Commission has considered your request for advice as to whether the proposed sale of Gulf's Cedar Bayou, Texas, polypropylene plant to Amoco Chemical Company, a subsidiary of Standard Oil Company (Indiana), is subject to the prior approval of the Commission under the order in this case, issued October 24, 1984.

The order requires Chevron and Gulf to obtain the prior approval of the Commission before selling any of Gulf's "oil and gas related assets," until the properties identified in Schedule A of the order have been divested. As defined in the order, "oil and gas related assets" include, among other things, assets and operations relating to "petroleum and petrochemical processing."

According to Gulf's request for advice, Gulf's Cedar Bayou plant produces polypropylene, a plastic. Polypropylene is made by polymerizing propylene, a petrochemical, into solid form.

On the basis of the information submitted and other relevant information, the Commission has determined that because the Cedar Bayou plant manufactures polypropylene using propylene as a feedstock, the plant is engaged in "petrochemical processing" and is an "oil and gas related asset" within the meaning of the order. Accordingly, the Commission has determined that the proposed sale of Gulf's Cedar Bayou polypropylene plant is subject to the prior approval of the Commission under the terms of the order.

Gulf's request was placed on the public record on October 25, 1984, and will be on the public record for thirty days until November 26, 1984. After the public comment period has ended, the Commission will consider the request, the comments received and other information, and will determine whether to approve the proposed sale.

By direction of the Commission.

Letter of Request

GULF OIL CORPORATION'S REQUEST FOR ADVICE AS TO COMPLIANCE WITH A COMMISSION ORDER OR, IN THE ALTERNATIVE, APPLICATION FOR APPROVAL TO DIVEST POLYPROPYLENE ASSETS

Parties and Jurisdiction

1. Gulf Oil Corporation (hereinafter "Gulf") is a wholly-owned subsidiary of Chevron Corporation (hereinafter "Chevron"), formerly Standard Oil Company of California (hereinafter "Socal").

2. On March 5, 1984, Gulf's then 100% parent, Gulf Corporation, and Socal entered into a Merger Agreement whereby Socal would acquire Gulf Corp. and its subsidiary, Gulf. A copy of the Merger Agreement is contained in the Appendix as Exhibit A.*

3. The Merger Agreement was amended on May 15, 1984 by a First Amendment which changed none of the substance of the Merger Agreement, but did correct minor errors in form. A copy of the First Amendment is contained in the Appendix as Exhibit B.

4. The Federal Trade Commission (hereinafter "the FTC" or "the Commission") initially approved the merger—subject to certain conditions—in an April 26, 1984 Agreement Containing Consent Order (hereinafter "the Consent Order"). A copy of the Consent Order is contained in the Appendix as Exhibit C.

5. The Consent Order incorporated in Paragraph II(C) a distinct Agreement to Hold Separate (hereinafter "the Hold Separate Agreement") affecting principally Gulf's domestic oil and gas assets. A copy of the Hold Separate Agreement is contained in the Appendix as Exhibit D.

6. Gulf wishes to proceed with its agreement to sell its polypropylene business, including the plant located in Gulf's Cedar Bayou facility approximately thirty (30) miles east of Houston, Texas, to Amoco Chemicals Company (hereinafter "Amoco"), a subsidiary of Standard Oil Company (Indiana). A copy of the December 19, 1983 letter of intent is contained in the Appendix as Exhibit E. A copy of the Inventory Sale and Interim Manufacturing Arrangements dated September 10, 1984 is contained in the Appendix as Exhibit F. A copy of the September 10, 1984 definitive agreement of sale (minus attached exhibits and schedules) is contained in the Appendix as Exhibit G.

7. Gulf and Amoco have previously made Hart-Scott-Rodino premerger notification filings with the Commission, including responses to second requests for information. The Commission staff has advised Gulf, however, that even if the proposed sale were to be found acceptable under Section Seven of the Clayton Act, 15 U.S.C. § 18, a second

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* Not reproduced herein. Copies of all Exhibits are available for inspection in Room 130, Public Reference Branch, Federal Trade Commission, 6th St. and Pa. Ave., N.W., Washington, D.C. 20580.

Commission approval would be needed under the terms of the Consent Order and Hold Separate Agreement. All efforts to resolve the matter informally at the Staff level have been unavailing, and Gulf now applies to the full Commission pursuant to FTC Rule of Practice 2.41(d) for an expedited order advising that neither Commission approval of the sale under the Consent Order and Hold Separate Agreement nor a period for public comment is needed. Should the Commission advise that the agreement of sale is one covered by the Consent Order and Hold Separate Agreement, then Gulf applies under FTC Rule of Practice § 2.41(f) for approval to divest its polypropylene business, subject only to a favorable decision on Section Seven grounds.

The Product and Its Uses

8. Polypropylene is one polymer in the polyolefin family of thermoplastic resins. All thermoplastic resins are derived by polymerizing petrochemicals into solid form. All thermoplastic resins are capable of being resoftened, usually by the application of heat and pressure. Typically, polypropylene is used in fiber, film, wire insulation, housewares, medical wares, and molded parts. A specific example is the plastic casing of an automobile battery.

History of Gulf's Polypropylene Business

9. Gulf's Cedar Bayou chemical plant produces ethylene, propylene, several ethylene derivatives, and polypropylene, a propylene derivative. Gulf entered the polypropylene business in the mid-1970's as part of a plan to integrate downstream into another polyolefin and to utilize propylene produced as a by-product in the manufacture of ethylene. In 1975 Gulf licensed the necessary technology, began construction of a polypropylene plant at the Cedar Bayou complex, and started buying polypropylene for resale. Gulf continued to purchase polypropylene manufactured by others even after late 1978 when its own plant began commercial production. Gulf's gross investment in the plant is over $120,000,000.

10. Unfortunately, Gulf has never earned a return on that investment. Indeed, it has lost substantial sums every year of its operation. A chart showing those losses is contained in the Appendix as Exhibit H. Operating losses for 1984 are projected, and the end is not in sight. Several million dollars in additional investments in technology, plant, and equipment would be necessary to improve the chances for profitability, and Gulf's Board of Directors decided in 1983 to cut its losses and to withdraw from the polypropylene business. While the execution of that decision was left to others, the message was clear. The plant was to be sold or closed by the end of 1984.

The Search for a Buyer

11. Gulf then identified companies whose existing businesses might fit well with Gulf's or foreign companies which might be interested in a toe-hold acquisition in the United States. All fifteen companies so identified were approached by Gulf with offers. Some received offers to sell all Gulf's olefin and olefin derivatives business. Others were offered polypropylene. Only Amoco gave a positive response. No other potential buyer exists.

The Agreement with Amoco

12. Gulf and Amoco entered into the letter of intent dated December 19, 1983 (Exhibit E, above). The Board of Directors of Gulf approved the sale to Amoco at a February 14, 1984, board meeting. Somewhat later, Amoco's board approved the transaction, and an interim agreement (Exhibit F, above) was signed on September 10, 1984. A final agreement (Exhibit G, above) was signed September 10, 1984 calling for the sale by Gulf of

(a) the polypropylene production facilities at Gulf's Cedar Bayou, Texas complex,

(b) approximately nine million pounds of polypropylene inventories,

(c) a warehouse and four shop buildings,

(d) a license for the technology used in the plant,

(e) polypropylene patents (none of which are used in production) and incidental know-how,

(f) leases for 398 hopper cars,

(g) polypropylene marketing records, and

(h) certain of Gulf's polypropylene contract obligations.

On October 1, 1984, Gulf would have commenced to dedicate the output of its polypropylene plant to Amoco under a toll processing arrangement. A closing for the sale of the plant facilities, *i.e.*, the "hardware," is scheduled for January 1, 1985.

The Commission Was Advised of the Proposed Sale

13. Gulf has kept the Commission fully informed of Gulf's intent to sell its polypropylene business to Amoco. Treating the sale as the separate transaction that it is, Gulf made its first Hart-Scott-Rodino filing as to this polypropylene transaction on February 1, 1984. A second Gulf filing in response to a request for additional information about the proposed sale was made on September 4, 1984. Gulf also notified the Commission during the course of the Socal/Gulf merger proceedings. Documents relating to the impending sale of the polypropylene business were produced by April 2, 1984, in response to specifications 8 and 8b of the Commission's second request for information.

The December 19, 1983 letter agreement in particular bears production numbers GC 00110023–56 and should be located in FTC Box 24.

The Commission Staff's Position

14. By letter dated September 21, 1984, the Commission staff advised that "Although the Commission has not decided the issue . . . ," Gulf's proposed sale of its polypropylene plant might well be the sale of an "oil and gas asset" under Paragraph 2(h) of the Agreement to Hold Separate that would require specific Commission approval prior to sale. A copy of the Staff's letter is contained in the Appendix as Exhibit I.

The Polypropylene Business Sale Is Not Covered by the Consent Order

15. The Commission should advise that the proposed sale of the polypropylene business without prior FTC approval is in compliance with the Consent Order, *i.e.*, does not violate the Consent Order, because the proposed sale is not covered by the Consent Order. The Consent Order clearly covers the sale of the properties listed in Schedule A of the Order. Those properties must be divested as part of the agreement with the Commission. The FTC Staff is *not* contending that the sale of the polypropylene business is a sale of a Schedule A property.

16. Rather, the Staff is contending that the agreement to sell the polypropylene plant *may* be an agreement to sell an asset that requires prior Commission approval under Paragraph 2(h) of the Hold Separate Agreement. Paragraph 2(h) reads as follows:

> Nothing herein shall prevent the current Gulf Board or the New Board from negotiating or entering into agreements to dispose of Gulf's assets, provided that any such agreements with respect to oil and gas related assets and businesses are conditioned on and not consummated prior to final approval by the Commission.

The term "oil and gas related assets and businesses" is defined in Paragraph I(b) of the Consent Order which states:

> "Oil and gas assets and businesses" means all Gulf's domestic crude oil and gas, and assets and operations relating to oil and gas exploration, production and transportation, as well as petroleum and petrochemical processing, refining, transportation and marketing activities, and any similar foreign activities to the extent involved in imports into the United States.

The Staff seems to have focused its attention only on seeking a determination from the Commission whether the polypropylene business is an oil and gas related asset or business. Whether it is or not becomes irrelevant if the agreement to sell is not covered by Paragraph 2(h) of the Hold Separate Agreement.

17. The language used in Paragraph 2(h) shows that the parties to the Hold Separate Agreement all contemplated a prospective application of the restrictive proviso of Paragraph 2(h). The words "negotiating or entering into agreements" clearly contemplate new agreements from the date of the Consent Order forward in time until the provisions of the Consent Order have been satisfied. Just as clearly, the language does not apply retrospectively to a proposed sale of assets already negotiated and approved by the Gulf Board of Directors. There is no question that the proposed sale to Amoco to dispose of the polypropylene business pre-dated the Consent Order and Agreement to Hold Separate. There is equally no doubt that the Federal Trade Commission was fully aware of the agreement to sell the business. As noted above in Paragraph 12, the December 19, 1983 letter of intent with Amoco was signed before the Merger Agreement with Socal. Gulf's first Hart-Scott-Rodino filing regarding this polypropylene sale had been made before the Merger Agreement with Socal. Gulf's Board of Directors had approved the sale to Amoco before the merger agreement. The proposed sale was brought to the Commission's attention a second time within the responses to specifications requesting additional information. All this occurred before the Commission entered its Consent Order and Hold Separate Agreement.

18. Equally important, the polypropylene business is not and should not be considered an oil and gas related asset or business. After the decision was made to sell the business, it could not reasonably be considered to be part of Gulf's ongoing operations. See the September 21, 1984 letter and memorandum from Bernard J. McNamee to Gordon Youngwood contained in the Appendix as Exhibit J. The polypropylene business was an asset only in the sense that it represented potential sale proceeds. It was a claim against a proposed buyer's cash. It was not considered an oil and gas related asset or business, but rather an account receivable.

19. Finally, the definition of "oil and gas related assets and businesses" does not include polypropylene. The only conceivable argument to the contrary apparently arises from the inclusion in the definition of the term . . . "petrochemical processing." Polypropylene is a thermoplastic polymer, produced in solid pellet form. It is the result of polymerizing propylene with or without monomers. It is categorized under Standard Industrial Classification 2821–351. Petrochemicals, on the other hand, are classified under Standard Industrial Classification Numbers 2869 and 2911. Petrochemicals are generally thought of as the refinery processing streams resulting in the primary olefins such as ethylene, propylene, and butadiene, and in aromatics, such as benzene, toluene, and xylenes. These products are liquids or gases, not solids. Derivatives of these products, such as high and low density polyethylene, polypropylene, polystyrene, and

nylon are regarded not as chemicals or petrochemicals, but as plastics.

Sale of the Polypropylene Plant Is Consistent with the Consent Order

20. Even *assuming* that the Consent Order applies to the agreement to sell the polypropylene business, the sale of that business is perfectly consistent with the purpose of the Order. The seventh WHEREAS clause in the premises of the Agreement to Hold Separate reads:

> *Whereas,* the purpose of this Agreement and the Consent Order is to preserve Gulf as a viable, integrated petroleum company pending the divestiture of the Schedule A properties as viable, ongoing enterprises, in order to remedy any anticompetitive effects of the Acquisition and to preserve Gulf as a viable, integrated petroleum company in the event that divestiture is not achieved; . . . .

Gulf's viability is enhanced, not diminished, by the sale of the polypropylene business. Gulf's polypropylene business has been a consistent money loser. Selling the operation will stop those losses. If the Consent Order applies, Commission approval of that sale is needed. Withholding Commission approval of the sale would be directly contrary to the purpose of the Consent Order and Agreement to Hold Separate. They would have been interpreted in a way that makes Gulf less viable than it was.

21. Likewise, the fifth WHEREAS clause in the premises begins with the following language:

> *Whereas,* the Commission is concerned that if an understanding is not reached preserving the *status quo ante* of Gulf's oil and gas assets and businesses during the period prior to the divestiture of the properties described on Schedule A of the Consent Order . . . .

Clearly, the *status quo ante* with regard to the polypropylene business was that it was going to be sold or closed. Approving the sale is consistent with preserving the *status quo ante* because it preserves a decision made before the Consent Order and Agreement to Hold Separate. Withholding approval of the sale is contrary to preserving the *status quo ante* because it will reverse a prior decision.

The Polypropylene Business Is Not Needed To Aid the Saleability of Schedule A Properties

22. It was thought at the time the Agreement to Hold Separate and Consent Order were entered that it might be necessary or desirable to divest some or all of Gulf's oil and gas related assets and businesses in addition to the Schedule A properties. Both the sixth WHEREAS clause of the Agreement to Hold Separate and Paragraph II(A) of the Consent Order reflect this. Whatever the likelihood at the time that

Gulf's money-losing polypropylene plant would be needed to enhance the sale of the more desirable Schedule A properties, that likelihood has totally disappeared in light of subsequent events. Chevron and Standard Oil Company of Ohio have reached an agreement which, if approved, will result in the divestiture of the marketing assets in eight southeastern states and the Alliance refinery. Clearly, this satisfactory solution for the bulk of the Schedule A properties has been attained without including the polypropylene plant.

23. Moreover, no reasonable argument can be advanced to support the proposition that the polypropylene plant is needed to aid the sale of Gulf's interest in the West Texas Gulf Pipeline Company or in the Colonial Pipeline. West Texas is a crude line. Gulf's polypropylene plant does not process crude. Colonial is a products pipeline which transports refined products in liquid form. Gulf's polypropylene plant produces solid pellets which are shipped in boxes or hopper cars. They cannot be shipped via the Colonial Pipeline.

There Is No Synergy Between the Polypropylene Plant and Gulf's Port Arthur Refinery

24. The Staff has suggested that possible synergies between the polypropylene plant and Gulf's Port Arthur refinery be considered. Apparently, the Staff reasons that the polypropylene plant ought not be sold because it might enhance the sale of the Port Arthur refinery. The obvious counter to this reasoning is that the Port Arthur refinery need not be sold to satisfy the Consent Order. Sohio has elected to purchase the Alliance refinery.

25. Moreover, synergy by definition includes combined action or operation. There simply is no combined action or operation between the polypropylene plant and Port Arthur which can result in a total effect greater than the sum of the two operations taken independently. It must be remembered that the Cedar Bayou complex contains a number of plants consuming different raw materials and functioning at different levels in the creation of products. The polypropylene plant cannot be equated with the Cedar Bayou complex as a whole. That complex produced products other than polypropylene for over fifteen (15) years before the polypropylene plant was built. Gulf's Cedar Bayou plant has the capacity to produce sufficient propylene for the polypropylene plant. However, Gulf's Cedar Bayou plant is not dependent on the Port Arthur refinery for feed stocks, nor is the Port Arthur refinery dependent upon Gulf's polypropylene plant as an outlet for its propylene production. Cedar Bayou buys feed stocks from Port Arthur only when the economics are favorable to Cedar Bayou. Other suppliers exist, and for several years Cedar Bayou has not purchased its major feedstocks from Port Arthur. Thus, there is no interdependence or combined operation between the polypropy-

lene plant and Port Arthur. The feed stocks which the Cedar Bayou plant obtains from time to time from the Port Arthur refinery would be consumed in the production processes at Cedar Bayou whether or not Gulf operates the polypropylene facility. Thus, there is no direct buy-sell relationship between the polypropylene plant and Port Arthur, and Gulf's polypropylene business does not affect whatever buy-sell relationship exists from time to time between the Cedar Bayou plant and the Port Arthur refinery. Selling or closing the polypropylene plant is simply irrelevant to that relationship.

26. It is also true that there are a number of pipelines between Port Arthur, Texas and the Cedar Bayou complex. A summary description of those lines is contained in the Appendix as Exhibit K. These pipelines are irrelevant, however, when, as noted above, there is no buy-sell relationship requiring pipeline transportation.

Time Is of the Essence

27. Amoco and Gulf had set October 1, 1984 as a date for the commencement of the toll processing arrangement. Because the Commission Staff stated that Amoco's response to the second request for information was not substantially in compliance, Amoco had to supply additional materials. As a result, the twenty (20) day period in which the Commission must indicate whether it will approve the acquisition now will expire on October 19, 1984. The transaction will not proceed without the consent of the Federal Trade Commission. The market place now perceives Gulf as exiting the market, and many customers have turned to and are being solicited by other suppliers. The value of the polypropylene business as an ongoing concern with a stable customer base is obviously greater than that of the plant hardware alone. If the transaction is canceled by Amoco for want of prompt approval by the Commission, the result will be a loss to everyone. Gulf and Amoco will each have lost the benefit of their bargain. The industry will have lost the productive capacity of the Cedar Bayou polypropylene plant, and, as a result, the concentration of industry capacity will be higher than if the plant had been sold to Amoco.

Conclusion

28. Gulf is before the Commission pursuant to Rule 2.41(d), seeking an advisory ruling that the proposed sale of the Cedar Bayou polypropylene business is in compliance with and not in violation of the Consent Order and Agreement to Hold Separate. They do not apply to the agreement to sell the plant to Amoco for two reasons. First, they are prospective in their scope, and the agreement of sale was negotiated and entered into before the date of the Consent Order and Agreement to Hold Separate. Second, the polypropylene business is

not an oil and gas related asset or business in either the financial or technical sense. Even if the agreement to sell the polypropylene business were within the scope of those documents, the sale of the business is perfectly consistent with their purpose. Selling the plant helps to maintain Gulf as a viable entity and in no way subtracts from the saleability of the Schedule A assets.

Time is of the essence in this transaction. Therefore an expedited ruling under Rule 2.41(d) that the transaction is not within the scope of the Order is preferable because it does not require a thirty (30) day period to await public comment. Approval of the sale under Rule 2.41(f) would achieve the same result, but would delay the transaction during the thirty (30) day public comment period.

Respectfully submitted,

/s/Barton D. Whitman
Attorney for Gulf Oil Corporation

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